FICKLE INVESTORS, REPUTATION, AND THE CLIENTELE EFFECT IN VENTURE CAPITAL FUNDS

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I. INTRODUCTION

Empirical work is hard. The world of venture capital—like the rest of the real world—is confusing, messy, and difficult to reduce to numbers. Empiricists have an understandable tendency to focus on things that are easy to measure, like a baseball scout measuring base-stealing potential by timing a prospect in a 60-yard dash.[1] Soft information like reputation, goodwill, or culture—or the knack for getting a good jump on the pitcher—sometimes gets ignored. So long as the soft information is trivial, we can still draw useful conclusions from the empirical analysis. I'm not sure this is one of those times.

In her Article, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, Professor Litvak sets out to explain why venture capital investors stage their investments. Investors commit to provide a large amount of capital but provide it only on an as-needed basis. Because investors might default on their obligation to answer capital calls, partnership agreements appear to be inefficient. Why create this unnecessary liquidity risk? Litvak argues that this arrangement is a governance mechanism meant to give investors a way to pull out of funds that are underperforming.

Litvak organizes her Article around the concept that it is helpful to characterize these walkaway rights as put options.[2] Using a sample

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1. *See* MICHAEL LEWIS, MONEYBALL: THE ART OF WINNING AN UNFAIR GAME 5-6 (2003). Baseball scouts are worse than economists, of course: they sometimes place too much emphasis on information that is difficult to measure (like grace) and not enough emphasis on information (like past performance) that is easy to measure but may contradict their preconceived notions of what good ballplayers look like. *See id.* at 14-42.

2. *See* Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Op-*

of 38 venture fund agreements, Litvak sets the harshness of the default penalty as her dependent variable.[3] She then runs regressions against several independent variables: fund size, fund number, fund vintage year, amount of carry, and so on.[4] Litvak finds a relationship between some of her proxies for fund governance and the harshness of default penalties. The threat of capital withdrawal, she concludes, is a useful contractual tool to reduce agency costs between investors and low-quality venture capitalists.[5]

I argue in this Essay that while it is conceptually accurate to characterize these walkaway rights as put options, it is not especially helpful to do so in this particular context. Practical considerations force Litvak to omit an important element from her model: the cost to an investor's reputation when it fails to heed a capital call. To draw any useful conclusions, Litvak must account accurately not only for the nominal penalty written in the contract, but also the real-world penalty of never being allowed to invest in the most prestigious venture capital funds ever again.

This reputation cost varies depending on the clientele of the fund. Pension funds, university endowments, and other repeat players have access to the most prestigious funds and care deeply about their reputations, while some individuals and corporate investors might be indifferent. And so the variation in contract default penalties might, in fact, be more strongly predicted by a clientele effect that Litvak does not and for practical purposes cannot accurately measure. In my mind, then, Litvak fails to make a persuasive case that governance considerations really have the effect she suggests.[6] Moreover, Litvak's theory does not seem to comport with recent real-world experience: the lemming-like answering of VC capital calls following the NASDAQ crash of March 2000.[7]

Finally, by ignoring the clientele of the funds, Litvak misses a possible regulatory explanation for the practice of staging capital contributions: the Department of Labor "plan asset" regulations that gov-

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tions in Venture Capital Partnership Agreements, 40 WILLAMETTE L. REV. 771, 773-74 (2004). A put option is a financial contract that gives the holder the right, but not the obligation, to sell an asset at a pre-determined price at a given date or term in the future.

3. *See id*. at 776. Litvak also looks at the "option term": the minimum number of years that a fund may take to take down the committed capital. *See id.*

4. *See id*.

5. *See id*. at 777.

6. *See infra* at Part II.

7. *See infra* at Part III.

ern pension funds subject to ERISA.[8] Most venture funds include investors subject to ERISA. To qualify as "venture capital operating companies," or VCOCs, and thus to avoid violating ERISA, most venture funds have no choice but to take down capital on an as-needed basis. Litvak's puzzle, then, is better explained as a necessary response to regulation than as an elaborate system of governance.

8. *See infra* at Part IV.