

GOVERNANCE THROUGH EXIT: DEFAULT PENALTIES AND WALKAWAY OPTIONS IN VENTURE CAPITAL PARTNERSHIP AGREEMENTS

KATE LITVAK*

ABSTRACT

When investors sign venture capital partnership agreements, they do not immediately turn over the entire committed capital. Instead, they contribute capital in stages, as needed by the fund. Typically, investors have at least three years to decide whether to honor their commitment obligations fully. To discourage investor defaults, venture funds employ a complicated system of financial penalties. Since venture funds could eliminate default risk altogether by demanding that investors contribute the entire amount initially, the question

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arises: why do venture funds engage in this elaborate staging scheme?

I suggest that staged contributions are a governance tool. The threat of investor walkaway creates incentives for venture capitalists to perform well. The walkaway right, however, can undermine a fund's liquidity and threaten its ability to invest in a timely fashion. Thus, my governance hypothesis predicts that the strength of investor walkaway rights reflects a tradeoff between governance concerns and liquidity concerns. The higher are agency costs associated with the fund, the more liberal the walkaway regime.

I test this hypothesis by studying a sample of 38 venture capital partnership agreements. I find that the strength of investor walkaway rights is related to several measures of expected agency costs. Venture funds run by more prominent VCs give investors weaker walkaway rights. Similarly, venture funds where VC compensation is more heavily performance-based make capital withdrawals more difficult. Competing explanations receive little or no support. Also, different fund families, represented by the same law firm, use different provisions, so these provisions are not mere "boilerplate," copied by lawyers from one agreement to the next.

I. INTRODUCTION

In the venture capital industry, time is money. Anything that undermines a venture fund's ability to act in a timely manner places a fund at risk of losing business opportunities, partners, and reputation. Shocks to a fund's liquidity may have this effect. One might therefore think that venture funds would take apparently easy steps to reduce liquidity shocks—for example, by requiring investors to contribute all of their committed capital upfront, when the partnership agreement is signed.

This has not happened. Instead, when investors join a venture fund, they promise to supply capital in stages over a number of years, retaining the real option to default on their commitment obligations. Moreover, venture fund partnership agreements limit the portion of committed capital that a venture capitalist ("VC") can call annually as well as the purposes for which capital calls can be made. Typically, investors get two to five years before the VC can receive the entire committed amount.

Collecting the entire capital upfront is not the only way to protect a fund's future liquidity. An alternative is to let investors make contributions in stages, but make defaults prohibitively expensive by

slapping defaulters with a large penalty. This default penalty can be collected without litigation by providing for an automatic transfer of a defaulter's interest in the fund to non-defaulting investors. Yet this arrangement is also rare. Most of these default penalties are relatively modest: typically, a defaulter loses only a portion of its interest in a fund. Both the period in which capital can be called and the penalty for default vary widely across funds.

Why do we see these patterns? After all, a fund that offers its investors generous walkaway rights puts itself at a competitive disadvantage. Potential contractual partners (syndicating VCs or entrepreneurs of portfolio companies) may have to investigate not only the financial state of the fund, but also the current and expected financial state of its investors, and discount for the risk that the fund will not be able to honor its financial obligations because of investor defaults. These costs will be borne by the fund through foregone business opportunities, difficulty in attracting employees or persuading them to invest in fund-specific human capital, and transaction costs to replace defaulters with new investors.

The risk of investor defaults is not merely theoretical. Although no hard data is available, there is ample anecdotal evidence that venture capitalists and venture capital lawyers take the risk of investor default seriously, defaults occur with some frequency and can threaten the smooth operation of venture funds.¹ Therefore, the willingness of funds to grant investor walkaway rights needs to be explained. Academic literature has paid no attention at all to investor walkaway rights, and practitioner explanations are unsatisfactory.

This Article suggests that the investor right to walk away after signing a partnership agreement has governance value that offsets its liquidity-related costs. Granting dissatisfied investors the right to walk away places underperforming venture capitalists at a risk of seeing their fund disappear before their eyes. Just as staged financing of portfolio companies and the accompanying threat of VC walkaway improve incentives of entrepreneurs of portfolio companies, the threat of investor walkaway responds to agency costs for the VCs themselves.

In other words, when investors join a venture fund, they receive not only an interest in a fund, but also a valuable real option to walk away, which they can exercise before a fund is fully invested. We

1. See discussion *infra* Part II (discussing the real-world importance of investor defaults).

can think of investors as having invested fully at the onset and also retaining a put option. By defaulting, investors exercise the put, in effect selling their interest (or part of their interest) back to the fund at a strike price that is related to the default penalty specified in a partnership agreement.² Thus, we can use the severity of default penalties to measure the price tag attached to the exercise of the walkaway option. Likewise, partnership agreements specify a minimum *term* of the walkaway option, which can be derived from the provisions specifying what percentage of total commitments the VC may call annually.

An investor walkaway option becomes more valuable (a) when its term increases (that is, when the percentage limit on annual callable capital declines); (b) when the strike price increases (that is, when the default penalty declines); and (c) when uncertainty about VC quality increases (that is, when a VC is of lesser quality or when his performance is otherwise less certain).

The governance benefits of the walkaway option come at a cost in liquidity. The presence of both governance and liquidity considerations explains why we do not see either funds where investor walkaways go completely unpunished or funds where investor walkaways are not permitted at all.

This Article documents and examines this governance-liquidity tradeoff. I analyze the provisions of venture capital limited partnership agreements that determine the strength of the investor walkaway option—default penalties and minimum time periods before the fund is fully invested. I assess whether, across venture funds, these two elements of the investor put option vary in economically sensible ways. One can think of governance concerns and liquidity needs as two competing factors that can affect walkaway rights. If governance considerations are the dominant factor in determining the strength of investor walkaway rights, default penalties should be lower and option terms longer when investors' need to oversee venture capitalists' investment decisions is high—that is, in funds run by lower-quality or less-experienced VCs and funds where VC compensation is less sensitive to fund performance. If liquidity considerations are the dominant factor, default penalties should be lower and option terms longer when funds are less susceptible to liquidity shocks—that is, when funds are larger and run by higher-quality VCs who can more easily

2. The strike price of this put option is the value of the investor's interest that is being sold back to the fund minus the default penalty.

replace a defaulter.

These competing governance and liquidity hypotheses generate predictions that cover most of the possible relationships between the strength of investor walkaway rights and the characteristics of venture funds on which I have data. Still, one can think of other hypotheses whose predictions would be subsets of predictions generated by the governance and liquidity hypotheses. For example, investors may be deterred from defaulting not just by the threat of financial penalty, but also by the harm to the defaulting investor's reputation. If higher-quality investors with a long-term interest in venture investing (like pension funds and university endowments) are more reputation-conscious than lower-quality, non-repeat player investors (like individuals), and if higher-quality investors tend to congregate in top funds, better funds may impose lower financial penalties for defaults because financial penalties are complemented by strong reputational punishments. The predictions generated by this "investor reputation" hypothesis are a subset of the liquidity-based predictions—funds run by higher-quality VCs should have lower default penalties and longer option terms.

Another alternative hypothesis has to do with information costs.³ Strong walkaway rights increase the risk that a fund will fail to honor its own contractual commitments. As a result, a fund's potential contractual partners (syndicators and entrepreneurs) have to investigate the participants in such a fund (VCs and investors) more carefully. Higher-quality, reputable VCs likely have been investigated in the past; they are also more likely to have higher-quality, liquid investors with a history of venture investing, who have also been investigated in the past. Thus, business partners dealing with higher-quality venture funds incur lower information costs than those who deal with funds organized by newcomers and financed by no-name investors of uncertain liquidity. Since these information costs are ultimately borne by the funds themselves, higher-quality funds can afford to use more liberal walkaway regimes as governing tools because such regimes cost less to them. This "information costs" hypothesis generates predictions that are identical to investor-reputation predictions: lower-quality funds should employ higher default penalties and shorter option terms.

3. A version of the "information costs" hypothesis was developed in Henry Hansmann, Reinier Kraakman, and Richard Squire, *Legal Entities, Asset Partitioning, and the Evolution of Organizations* (unpublished manuscript, on file with the author).

A final “boilerplate” hypothesis is that default penalties and option terms are unimportant legal boilerplate. If so, these terms should vary randomly across funds, and will likely reflect which law firm the venture capitalist happens to have chosen.

To test these hypotheses, the Article studies partnership agreements of 38 venture capital funds raised by 18 U.S.-based venture capital firms between 1987 and 2003. I code the severity of default penalties on a scale from 1 (least severe) to 10 (most severe). I define the term of a walkaway option as equal to $100/(\text{maximum percent of capital commitment that VCs can call per year})$. I then ask whether the severity of the default penalty and the term of the walkaway option are predicted by factors that proxy for the fund’s need for governance and liquidity: VC quality (fund size, fund number, and overall level of VC compensation); riskiness of VC compensation (the relative and absolute size of carry and management fee); outside world conditions (the year when the fund was raised and the hotness of the venture capital market during that “vintage” year); alternative ways to address liquidity concerns (the fund’s ability to borrow); and alternative performance incentives employed by the fund (minimum mandatory coinvestment by the VC in the fund).

I find significant, albeit incomplete, support for the governance-based hypotheses. Controlling for other things, funds where VCs receive higher total compensation (that is, funds whose VCs are perceived by the market as being of higher quality) and funds where VC compensation is riskier make walkaway more difficult by employing shorter option terms. Also controlling for other things, larger funds (typically run by better VCs) are more likely to restrict walkaways by using higher default penalties. On the whole, funds that confront lesser agency problems give investors a weaker governance tool in the form of walkaway rights.

The liquidity hypothesis receives support only from areas in which the governance and liquidity explanations generate the same predictions: a positive relationship between the hotness of the venture capital markets and the strength of walkaway rights.

The investor-reputation hypothesis and the information-costs hypothesis receive no support in my data. Larger funds, which likely have higher-quality, reputation conscious investors, employ *higher* default penalties, which is consistent with the governance hypothesis but contradicts the reputation, information-costs, and liquidity hypotheses. Furthermore, liquidity, investor-reputation, and information-costs hypotheses cannot explain why funds using riskier compen-

sation grant investors weaker walkaway rights, controlling for VC quality.

The boilerplate hypothesis is also not supported. Walkaway rights vary in ways that are partly predictable based on governance and other economic factors, and are not predicted by the VC's choice of law firm.

Overall, my study provides evidence that investors stage their contributions in venture funds for the same reason as venture funds stage their own contributions in portfolio companies: to mitigate agency costs. In funds with higher agency costs, the term of the real option to default is longer and strike prices are higher (making exercise of the option more attractive).

This study may have broader implications for current debates about firm governance. First, it may explain investment patterns of institutional investors in areas beyond venture capital. In some areas of private equity, such as Leveraged Buyout (LBO) funds and real estate development, institutional investors invest in stages, just as in the VC industry, but cannot withdraw capital once invested. In other areas, like hedge funds, institutions usually invest the entire amount upfront but have more liberal rights to withdraw capital. A tradeoff between governance and liquidity concerns can help to explain this pattern. Venture and LBO funds draw money from investors in stages, but invest in illiquid assets and do not permit investors to withdraw capital and walk away once the money is invested. In contrast, hedge funds draw the entire committed capital initially, but invest in more liquid assets and allow investors to withdraw capital with some frequency, usually on a quarterly or annual basis. So, in both cases, investors receive put rights that they can exercise if dissatisfied with the performance of fund managers. These puts are structured differently in different industries, reflecting the different liquidity needs of those industries. But the general pattern cuts across most fields of private equity: investors get important put rights that help to keep money managers at check.

The second implication of my study has to do with corporate governance. In sharp contrast to private equity investors, shareholders of public corporations have no right to withdraw equity capital from a company: when they want to cash in their ownership rights, they have to sell their interest to someone else, which does not directly affect the company's capital. If my story of a tradeoff between governance and liquidity is correct, other governance mechanisms must work well (enough) for the no-walkaway regime to emerge as a

sensible choice in the corporate context. An interesting question for future research is which corporate governance or market factors make the use of put rights in corporations relatively unattractive.

A caveat: my sample size is small and not random. Partnership agreements are private, carefully guarded documents. My sample contains only agreements that were provided to me by venture capitalists and investors.

This Article proceeds as follows. In Part II, I discuss the evidence on investor defaults. Is the walkaway option long enough to play a real governance role? Do investors actually exercise walkaway rights? Are investor defaults triggered by governance considerations? Do defaults threaten funds' liquidity? Do industry participants view default penalties as a useful tool to manage investor defaults?

Part III discusses the installment system of capital contributions used in the venture capital industry, as well as my coding of default penalties and option terms.

Part IV frames my hypothesis that the optimal level of capital stability in venture funds depends on balancing of governance and liquidity concerns and specifies plausible factors that are testable using my dataset. It also discusses alternative testable hypotheses. Part V describes the data and variables. Part VI contains regressions and explains which hypotheses receive support in the data. The conclusion summarizes the findings.⁴

4. This Article is a part of a series of empirical studies of various aspects of VC limited partnership agreements. In other work, I study the terms of VC compensation. *See, e.g.*, Kate Litvak, *Venture Capital Partnership Agreements: Understanding Compensation Arrangements*, at <http://www.SSRN.com> (2004).