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Conservatism and Innovation in Venture Capital Contracting

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We conjecture that venture capitalists and their investors often fall prey to what is known as ‘collective conservatism.’ We investigate this conjecture by analyzing boilerplate provisions in limited partnership agreements. When investors accept suboptimal boilerplate provisions it is not because they believe that the standardized terms and conditions sufficiently align the interests of investors and fund managers, but merely because they think their peers, including their competitors, prefer to include them in the limited partnership agreement. We find that the financial crisis has facilitated some notable deviations in the boilerplate provisions that are aimed at returning confidence in the venture capital industry. We argue that a gradual shift may be taking place towards more investor-favorable limited partnership agreements or separate accounts and pledge funds arrangements. These shifts - which do not lead to significant changes in the limited partnership agreements - appear to be particularly effective for bigger funds that increasingly focus on later stage investments. We show that early stage funds are more inclined to enter into innovative collaborative agreements. Collaborative agreements differ from the traditional limited partnership agreements in that they focus less on curtailing principal agent problems and more on joint development and value creation.

Keywords: Collaborative Agreements, Collective Conservatism, Corporate Venture Capital, Government Venture Capital, Innovation, Limited Partnership Agreement, Micro-Venture Capital, Venture Capital Cycle

JEL Classifications: G24, K20, K22, L22, L26

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Abstract

We conjecture that venture capitalists and their investors often fall prey to what is known as ‘collective conservatism.’ We investigate this conjecture by analyzing boilerplate provisions in limited partnership agreements. When investors accept suboptimal boilerplate provisions it is not because they believe that the standardized terms and conditions sufficiently align the interests of investors and fund managers, but merely because they think their peers, including their competitors, prefer to include them in the limited partnership agreement. We find that the financial crisis has facilitated some notable deviations in the boilerplate provisions that are aimed at returning confidence in the venture capital industry. We argue that a gradual shift may be taking place towards more investor-favorable limited partnership agreements or separate accounts and pledge funds arrangements. These shifts - which do not lead to significant changes in the limited partnership agreements - appear to be particularly effective for bigger funds that increasingly focus on later stage investments. We show that early stage funds are more inclined to enter into innovative collaborative agreements. Collaborative agreements differ from the traditional limited partnership agreements in that they focus less on curtailing principal agent problems and more on joint development and value creation.

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Conservatism and Innovation in Venture Capital Contracting

Joseph A. McCahery[1] and Erik P.M. Vermeulen[2]

1. Introduction

Venture capitalists are at the heart of the innovative process and influence how entrepreneurial firms are funded. For instance, careful screening and financial analysis of business prospects enable venture capitalists to make reasonable projections about an investment's risks and likelihood of success. It has long been acknowledged that involving other firms in the screening and syndication process can contribute to more diversified and well-informed investors. Other important techniques are the use of convertible preferred securities, staged financing, monitoring of management teams, and to a lesser extent, the advice and expertise offered to entrepreneurial firms can limit the risk and help companies to meet their innovation and growth goals.[3] The lawyer-dominated market for reputation has been decisive also in ensuring the venture capitalists make investments in companies that are attractive to fund investors.[4] The agglomeration of these activities has been one of the most rapid sources of innovation, as they are necessary to bring the demand and supply side of venture capital together.

However, risk-averse behavior on the part of traditional venture capital firms and slowdown in fundraising has created a constraint on capital made available to new innovative firms. There is plenty of evidence that the quantity of capital invested in high growth companies dried up during the financial crisis due to the contradiction of the corporate debt market and the number of initial public offerings.[5] The imbalance in the supply and demand of venture capital has arguably altered the venture capital cycle, revealing a number of serious problems in the way we finance high growth firms.

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3 See generally Joseph A. McCahery and Luc Renneboog (eds.), Venture Capital Contracting and the Valuation of High Technology Firms (Oxford: Oxford University Press, 2003).
4 See, for instance, Sarah Murray, Lawyers to the Innovators: Specialist Needs, The Financial Times, 29 November 2012.
5 See Jose Miguel Mendoza and Erik P.M. Vermeulen, Towards a New Financial Market Segment for High tech Companies in Europe, in The European Financial Market in Transition (H.S. Birkmose, M. Neville and K. Engsig Sørensen eds.), (The Hague: KLuwer Law International, 2011).

Economists have generally been most optimistic about venture capitalists as being innovative because of their investment in relationships and on the spot evaluations.[6] From the point of view of evaluating alternative institutional arrangements, however, it is important to determine the factors that make venture capitalists choose risky or safe strategies.[7] In this paper, we examine how venture capitalists and their investors often fall prey to what is known as 'collective conservatism', which could be described as the tendency of a group of people to stick to an established way of thinking even if there are new developments that clearly call for a different mind-set or approach, and sometimes new investment models and practices.[8] Once established, this particular way of thinking is likely to become the model for how venture capital fund managers, investors, their advisers and other market participants interact in the future. Thus, if venture capitalists gain greatly from a conservative strategy, they lack an incentive to shift fundraising and investment strategies. Obviously, the model may become obsolete due to certain new developments in the environment that allow some venture capitalists to implement their own biases.[9] Ignoring these changes and refusing to shift to a new model will clearly generate hidden inefficiencies and costs.

A remarkable example of collective conservatism is the limited partnership agreement. Investors traditionally rely on the contractual flexibility of the fund's legal form (usually a limited partnership) in aligning the interests of fund managers and protecting their investments.[10] Indeed, the agreement traditionally focuses on reducing principal-agent problems between the venture capital fund managers and their investors. For instance, a fund's duration is usually ten years with a five years investment period, making it possible for investors to estimate with reasonable accuracy when the venture capital fund will make fresh investments and, most importantly, when they ultimately will be able to recover their investments, including profits. In order to align the interests within the venture capital fund, its managers are usually required to make a capital commitment. Typically the managers will invest 1%-2% of the fund's total capital commitments. Another key contractual technique for reducing the agency costs is the compensation arrangement between the fund managers and the investors. Compensation usually consists of two main sources. First, fund managers are typically entitled to receive 20% of the profits generated by each of the funds, the

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6 See Amar Bhide, A Call for Judgment, Sensible Finance for a Dynamic Economy, Oxford University Press, 2010.

7 See Andrew Winton and Vijay Yerramilli, Entrepreneurial Finance: Banks versus Venture Capital, 88 Journal of Financial Economics 51, 2008.

8 See Richard H. Thaler and Cass R. Sunstein, Nudge, Improving Decisions About Health, Wealth, and Happiness (New York: Penguin Books, 2009).

9 See Jeong-han Kang, A Typology of Organizational Behavior and Its Application of Diversification: US Venture Capital Firms, 1980-2004, Cornell University Center for the Study of Economy and Society, December 2006.

10 See Joseph A. McCahery and Erik P.M. Vermeulen, Corporate Governance of Non-Listed Companies (Oxford: Oxford University Press, 2008).

carried interest. A second source of compensation for the fund managers is the annual management fee, usually 2% - 2.5% of a fund's committed capital.

There is something to the focus on drafting contractual provisions that reduce principal-agent problems.[11] Investors in venture capital funds are often unable to monitor their investments closely, giving fund managers ample opportunity to act self-interestedly at the expense of the limited partners. Arguably, strict tried-and-tested standard terms and conditions in the limited partnership agreement are needed to reduce the information asymmetries between the investors and managers. Indeed, it is widely acknowledged among academics and practitioners that principal-agency based agreements are crucial for the development of robust venture capital markets in which investors are willing to make their money available for investments in start-up companies.[12]

Still, there are problems with pushing the so-called principal-agency based contractual mechanisms too far. Since the burst of the dot-com bubble in 2000-01, more venture capital has been invested in start-up companies than returned to the investors in venture capital funds, making it a relatively unattractive asset class for institutional investors.[13] The fact that payouts to venture capital fund investors show an 80% drop in the first half of 2011 compared with the same period in 2000 is a good example of the underperformance of the venture capital industry.[14] Of course, there are funds that significantly outperform the public market, creating high-profile growth and exit opportunities in successful start-up companies.[15] However, selecting the best-performing funds (with proven expertise and successful track records) is a challenging task.[16]

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11 See Kate Litvak, Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements, University of Texas Law and Economics Research Paper No. 29, 2004; Victor Fleischer, The Missing Preferred Return, Journal of Corporation Law, Vol. 31, 2005.

12 See, Ronald J. Gilson, Engineering Venture Capital Markets: Lessons from the American Experience, Stanford Law Review, Vol. 55, 2003.

13 See Diane Mulcahy, Bill Weeks and Harold S. Bradley, "We Have Met the Enemy… And He Is Us: Lessons from Twenty Years of the Kaufmann Foundation's Investments in Venture Capital funds and the Triumph of Hope over Experience", Ewing Marion Kauffman Foundation, May 2012. See also Robert S. Harris, Tim Jenkinson and Steven N. Kaplan, "Private Equity Performance: What Do We Know?", Working Paper, 18 February 2012; Felix Salmon, "How venture capital is broken", Reuters, 7 May, 2012.

14 See Amy Cortese, "Venture Capital, Withering and Dying", The New York Times, 21 October 2011.

15 See for European examples, Hendrik Brandis and Jason Whitmire, "Turning Venture Capital Data into Wisdom: Why returns in Europe are now outpacing the U.S.", Earlybird Europe Venture Capital Report, 28 July 2011.

16 See GO4Venture, "Monthly European Technology Venture Capital Bulletin", September 2010, <http://www.go4venture.com/content/HTI/2010/2010_091_Go4Bulletin.pdf>last accessed on 11 February 2013. A study shows that institutional investors lost faith in the European venture capital industry. Only 3% believe that the European venture capital funds will be able to provide their investors with strong return over the next decade. See Coller Capital, "Global Private Equity Barometer Winter 2010-11", 18 January 2011.

Research in law and economics often suggests that limited partnership provisions require updating and retooling in order to better deal with the high degree of information asymmetries.[17] Investors should negotiate stricter terms regarding the distribution of profits to managers, the possibility to remove managers or dissolve the fund, the inclusion of key-person provisions, and less severe penalties for defaulting limited partners. These arguments imply that collective conservatism – in terms of acquiescence in the traditional venture capital agreements, even if they are not ideally suited to the investors – negatively affects the development of a robust venture capital industry.

This paper, however, argues that the limited partnership arrangements should not only focus on reducing principal-agent problems. There is more to venture capital investments than the alignment of parties' interests. A focus solely on these issues will eventually crowd out the supply of venture capital. It is time to redirect the venture capital discussion from principal agent issues to investment dynamics, in which the human factor, trust, collaborations and value creation are the most important elements. We emphasize that recent trends and developments seem to capture the investment dynamics, suggesting that the market contains adaptive and self-adjusting mechanisms that reduce the persistence of inefficiencies in the venture capital industry.[18]

Our purpose in this paper is to suggest 'new' venture capital models that provide important recommendations for venture capital fund managers, investors, and their advisors that generally fail to maintain or create a vibrant entrepreneurial and venture capital culture. Moreover, a clear understanding of these 'new' models, which have ramifications felt across the venture capital industries, holds important lessons for policymakers and academics. These lessons go beyond and even contradict conventional thinking about venture capital and entrepreneurship.

The remainder of the paper is organized as follows. In the next section, we focus on recent trends and changes in the venture capital industry. Section III presents a series of stylized facts and evidence about changes – particularly patching-up revisions – in the design of limited partnership agreements that set the stage for our conjecture about the underlying developments taking place in the venture capital industry. Section IV discusses the evolution in the fundraising landscape, leading to a 'new' venture capital cycle with 'new' types of investors and 'new' opportunities. It is argued that innovative venture capitalists should take these new trends and developments into account when

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17 See George G. Triantis, Financial Contract Design in the World of Venture Capital, 68 University of Chicago Law Review 305, 2001.

18 See Mike Kwatinetz and Cameron Lester, Investing at the Bottom of the Venture Capital Cycle, The New York Times, Dealbook, 14 March 2012; See also Katerina Linos, Path Dependence in Discrimination Law: Employment Cases in the United States and the European Union, The Yale Journal of International Law, Vol. 35, 2010.

deciding on how best to structure future venture capital funds (and their underlying partnership agreements). Section V concludes.

2. Trends and Developments in the Venture Capital Industry

In Section II, we describe the development of certain characteristics of the 'venture capital cycle' model over the last two decades to generalize facts about the industry. The venture capital cycle traditionally starts with the creation of funds that raise capital from particularly institutional investors – which are generally viewed as reliable investors that are able to commit capital for the entire life of the fund – in order to back high potential start-up companies.[19] This is captured in Figure 1, which shows that the funds then select a manageable number of portfolio companies, which they nurture and support by contributing capital that these companies need to reach the next stage in their development. In addition, they offer advice and governance. Ideally, this continues until the moment that the fund managers decide to exit the portfolio companies and reap the fruits of the investments. A significant part of the returns are then distributed back to the funds' investors, enabling the restart of a new venture capital cycle by raising new funds.[20] It follows from this brief discussion that a rapid and smooth process of raising, structuring, operating and exiting funds is not only crucial to start and restart venture capital cycles, but also to develop a sustainable and robust venture capital industry. It is indeed plausible that more and bigger venture capital funds will solve the imbalance between the supply and demand sides of venture capital.

As a guideline for explaining the structure of the venture capital industry, the 'venture cycle' model arguably runs into three serious problems. First, the 'venture capital cycle' serves as a good description of the industry as it existed in Silicon Valley in the late 1980s and 1990s when IPOs were the dominant and preferred exit route.[21] During this period (and in Silicon Valley), there was an almost perfect balance between the supply and demand of venture capital.[22] Venture capital fund investments were typically made across a wide range of investment stages, from seed/start-up to early-stage, expansion and finally later-stage investments.[23] We are well aware of the success stories of entrepreneurs that started their businesses – and developed their innovative ideas – in garages and basements and built them into publicly listed multinationals. The Silicon Valley model, however,

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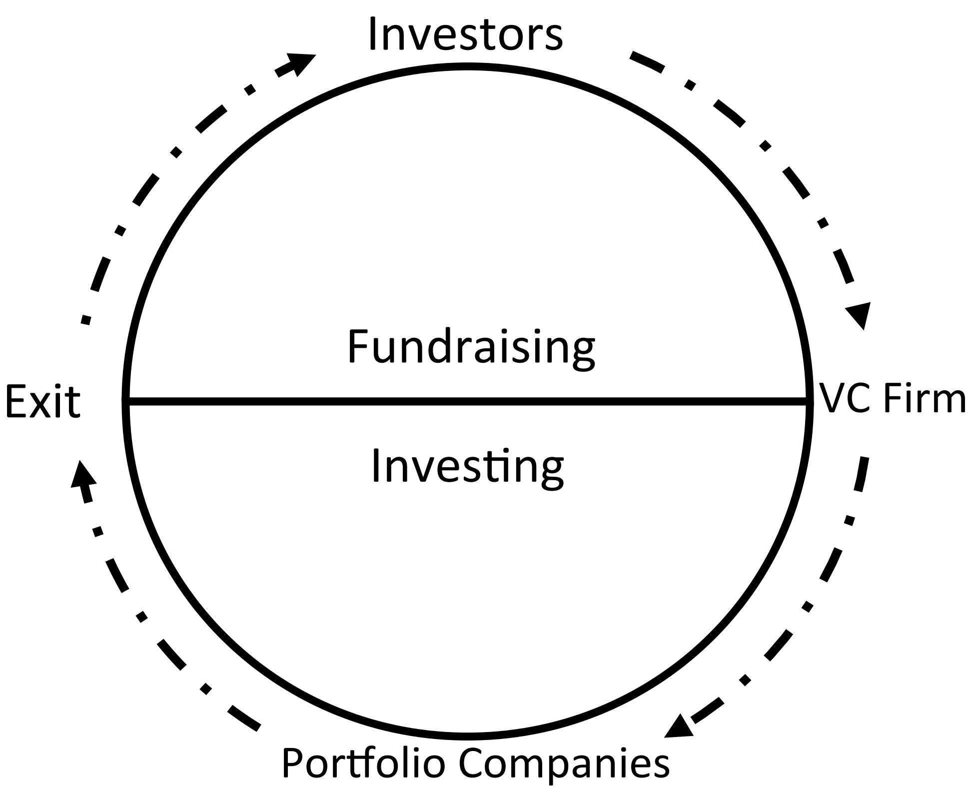
19 See Janet Kiholm Smith and Richard L. Smith, Entrepreneurial Finance, John Wiley & Sons, 2004.
20 See Paul Gompers and Josh Lerner, The Venture Capital Cycle, The MIT Press, 1999.
21 See James Freeman, Kate Mitchell: How Silicon Valley Won in Washington, A Democratic venture capitalist describes the small miracle of a pro-growth bipartisan success, Wall Street Journal (Opinion), 6 April 2012. See also John Armour and Douglas J. Cumming, The Legislative Road to Silicon Valley, Oxford Economic Papers, vol. 58, 2006.
22 See Mike Kwatinetz and Cameron Lester, Investing at the Bottom of the Venture Capital Cycle, The New York Times, DealBook, 14 March 2012.
23 See Andrew Metric and Ayako Yasuda, Venture Capital & the Finance of Innovation, Wiley, 2010.

is not easily replicated.[24] For instance, an array of policy and regulatory measures has been introduced over the last two decades in Europe. So far, however, these measures have not resulted in the emergence of a vibrant venture capital market.[25] The pan-European stock exchange, EASDAQ, is an example of a failed attempt to replicate the US' exit market success. These past attempts to mimic Silicon Valley's entrepreneurial success expose one of the flaws in the 'venture capital cycle' model. It overemphasizes the importance of its ingredients (institutional investors, venture capitalists, entrepreneurs and exit venues) and largely ignores the ecosystem and interactive networks that make the cycle self-propelling.[26]

Figure 1: The Venture Capital Cycle



24 See, for instance, Josh Lerner, Boulevard of Broken Dreams, Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed – and What to Do About It, Princeton University Press, 2009.
25 See European Commission, 'Impact Assessment accompanying the document Proposal for a Regulation of the European Parliament and of the Council on European Venture Capital Funds', Commission Staff Working Paper, SEC(2011) 1515, <http://ec.europa.eu/internal_market/investment/docs/venture_capital/111207-impact-assessment_en.pdf>.
26 See Victor W. Hwang and Greg Horowitt, The Secret to Building the Next Silicon Valley, Regenwald, 2012; Victor Hwang, To replicate Silicon Valley's success, focus on culture, 26 April 2012. See also Joseph A. McCahery and Erik P.M. Vermeulen, Venture Capital Beyond the Financial Crisis, How Corporate Venturing Boosts New Entrepreneurial Clusters (and Assists Governments in Their Innovation Efforts), Capital Markets Law Journal, Vol. 5, 2010.

The second problem with a strong adherence to the traditional 'venture capital cycle' model is that it assumes that the model can withstand the test of time and location. Venture capitalists, investors, and policymakers (in particular) should realize that certain contractual, legal and fiscal measures may sound accurate and appropriate in terms of market failures in a Silicon Valley-type setting before the burst of the dot-com bubble, but may be fundamentally at odds with the way the venture capital industry is currently organized in other parts of the world. Ignoring specific characteristics and recent trends and developments in the industry can lead to costly miscalculations. For instance, policy initiatives that only focus on early stage venture capitalists could crowd out the supply of risk capital in the later stages of a start-up company's development. Consider the case studies and empirical papers that show how tax incentives to encourage individual investors to pour money into special venture capital vehicles reduced the supply of other, relatively more informed venture capital investments.[27] It appears that the crowd-out effect is particularly strong if not all players in the venture capital industry benefit from the regulations (or are exempted from strict regulations).

The third problem is that policymakers, practitioners and academics are convinced that strict contractual mechanisms that aim at reducing principal agent problems form the essence of a virtuous 'venture capital cycle'. Until now the fundraising process is dominated by the view that the interest of the venture capital fund managers must be aligned with that of the investors. However, this so-called agency theory is arguably obsolete. Agency-based research and practice have framed fundraising in a way that is now unproductive and sometimes destructive. For instance, we observe a significant drop in fundraising on a global scale with 133 funds raising an aggregate amount of $32.3bn (and holding a final close) in 2011, down from $63.6bn across 259 funds holding a final close in 2007.[28] At the same time, raising the desired fund size has taken considerably longer for venture capital funds that closed in 2011. In 2007, the average time to the final closing of a fund was approximately 12 months. In 2011, it took approximately 18.5 months to reach a final closing.[29] The dramatic change in pre-financial crisis fundraising levels compared to post-financial crisis fundraising levels is mainly triggered by the fact that institutional investors started to massively shy away from investing in venture capital funds.[30]

These changed institutional features imply that the 'venture capital cycle' should be viewed as an evolutionary process. This is to say, that the 'venture capital cycle' is not uniform and static, but

27 See Douglas Cumming and Jeffrey MacIntosh, Crowding Out Private Equity: Canadian Evidence, Journal of Business Venturing, vol. 21, 2006.

[28] Data derived from data provider Preqin.

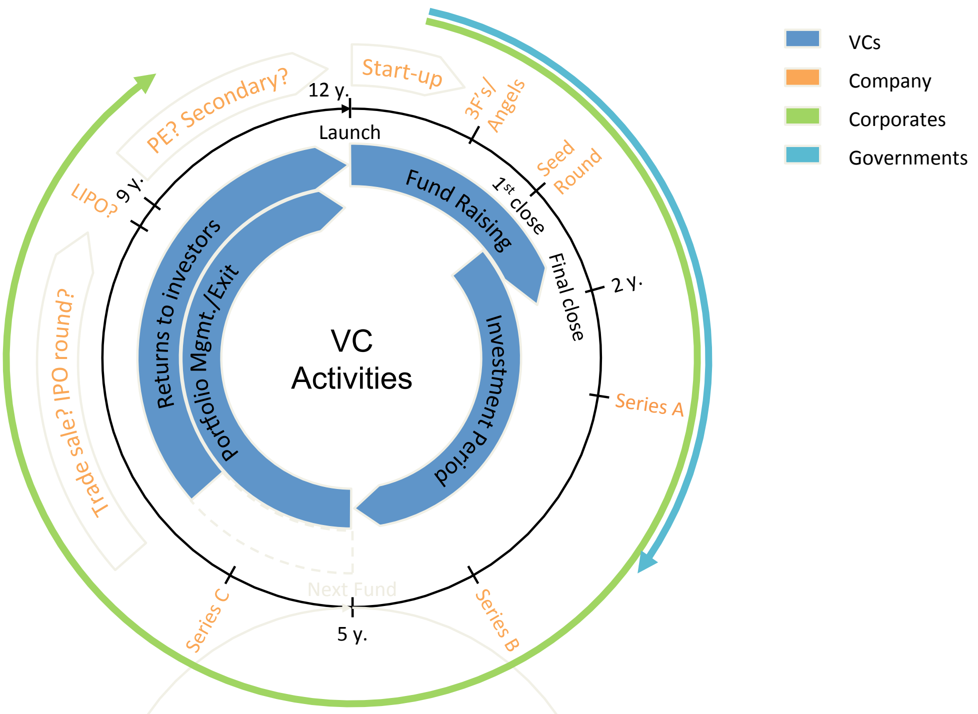
[29] See also Preqin Research Report, 2011 Private Equity Fundraising.

30 See Udayan Gupta, "Why institutional investors are turning down venture funds", Institutional Investor, 21 September 2010.

diverse and dynamic. It evolves over time and responds to changing needs and circumstances in the industry. Due to the evolutionary nature, the venture capital industry is arguably resilient and able to rebound from failures and setbacks.[31] We focus on four important observations below.

First, whilst we see more conservative investments in the form of expansion and later stage investments, new categories of investors, such as crowdfunding platforms, super-angels and multinational corporations have stepped up to fill the 'investment' gap in the early stages of the cycle (Figure 2).

Figure 2: The 'New' Venture Capital Cycle

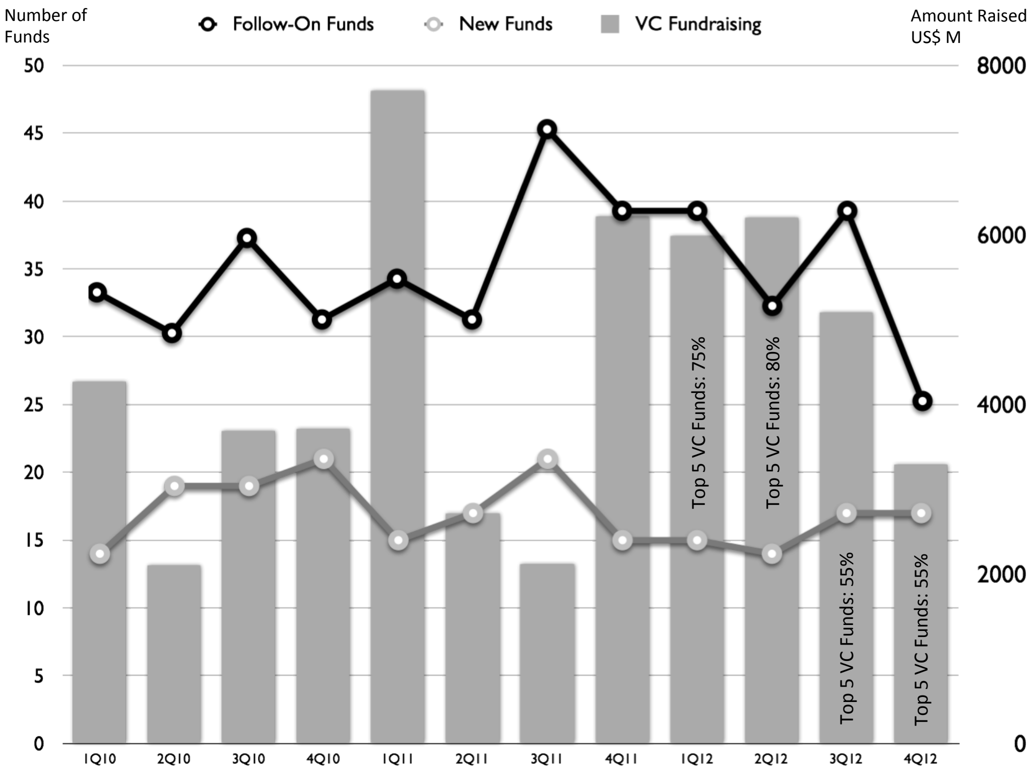


Second, we see a changed pattern in fundraising.[32] There is 'survival of the fittest' evidence that the number of active venture capital funds has significantly declined in the last five years.[33] Apparently,

31 See, for instance, Preqin, Venture capital deals activity edges up in Q2 2012, Private Equity Wire, 5 July 2012.
32 See also Mike Kwatinetz and Cameron Lester, Investing at the Bottom of the Venture Capital Cycle, The New York Times (DealBook), 14 March 2011 (indicating that the scarcity of capital created a Darwinian effect with a new breed of start-ups in which innovation-induced growth rather than capital-induced growth prevails).
33 See John Backus and Todd Hixon, Venture capital's new golden age, CNNMoney, 21 May 2012 (http://finance.fortune.cnn.com/2012/05/21/venture-capitals-new-golden-age/) (last accessed on 1 August 2012).

the financial crisis and uncertain economic outlook have caused many managers to close offices or shut down completely. An increasing number of venture capital firms hopes for a better future by extending the duration of their funds.[34] Only high quality funds seem to have a reasonable chance of receiving continuous funding for their activities. Indeed, institutional investors have largely chosen to invest only in the best performing and most highly reputed funds (See Figure 3).

Figure 3: Fundraising in the United States (based on new capital commitments) ($M)



Source: Data from Thomson Reuters/National Venture Capital Association

Third, empirical research shows that institutional investors take an increasingly active approach to the management of the funds, evidenced by the inclusion of investor favorable terms and conditions in the venture capital fund agreements.[35] It is interesting to see that also the high quality fund managers are put in weaker bargaining positions.[36]

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34 Empirical research shows that in the wake of the financial crisis 85% of the surveyed institutional investors had received a request for a fund extension over a one-year period. See Private Equity International, Institutional Investor Sentiment Survey, July 2012.

35 See Nicholas Donato, LPs demanding greater clarity in fund terms, Private Equity International, 16 August 2011.

36 Survey: LPs get tough on management fees, Private Equity International, 7 August 2012.

Fourth, besides patching up revisions to the limited partnership agreement (focusing on reducing the principal agent issues), we see that fund managers themselves promise to make significant capital contributions to their own funds. By putting more skin in the game they hope to attract more active (and often patient) investors. Governments, corporate venture capital groups, family offices, hedge funds, venture capital funds and former entrepreneurs increasingly become anchor investors in venture capital funds.[37] Indeed, with the financial crunch and the subsequent economic downturn having taken its toll, government venture capital is set to play a new role in the evolution of the venture capital industry. We already observe that governments, aware of the fact that the financial crisis offers new opportunities, increasingly partner with venture capital funds and corporations to kick-start entrepreneurship. Moreover, in a sluggish stock market, venture capital funds see benefits in entering into a partnership-type relationship with other funds and corporations. This partly explains the revival of corporate venture capital initiatives since the burst of the Internet bubble in 2001. Collaborations in the fundraising process are even taken a step further if fund managers decide to select their investors on what researchers have called ability-based and affinity-based characteristics.[38]

What constitutes the beginning, however, of a new institutional framework is hard to determine. The critical question, from our perspective, is whether we can observe the emergence of new contractual practices in the venture capital industry? We unravel the answers to this question below.

3. Revisions to Limited Partnership Agreements

Venture capital funds around the world predominantly employ the limited partnership or an equivalent flexible business form. There are obvious reasons for this, such as tax benefits and the flexibility surrounding its organization, structure and terms. Individuals and institutions that invest in a limited partnership choose to delegate investment and monitoring decisions to the venture capitalists, who act as the general partners. The relationship between the limited partners and general partners is usually characterized as a principal-agent relationship. In order to make this work, legal practice tends to include boilerplate clauses in the limited partnership agreement that are designed to reduce the agency costs by aligning the incentives of the general partners with the interests of the investors. The boilerplate arrangements in venture capital limited partnerships can roughly be split in three separate categories (1) fund formation and operation provisions, such as

37 See James Mawson, Corporate Venturing in the UK, RSA Projects, 2012. See also Jonathan Loules, UK risks losing vital corporate funding, The Financial Times, 20 July 2012; John Taylor, Corporate Venture Capital Remeined Strong in Q2 2012, Research and Trends, NVCACCESS, 26 July 20120 (http://nvcaccess.nvca.org/index.php/topics/research-and-trends.html) (last accessed on 10 August 2012).
38See Paul Gompers, Vladimir Mukharlyamov and Yuhai Xuan, "The Cost of Friendship", NBER Working Paper Series, Working Paper 18141 (June 2012).

limits on the fund-raising period, the lifespan of the fund, and the required managers' contribution, (2) management fees and carried interest, and (3) the governance structure to ensure that the fund is organized and managed in the most effective manner.

As the foregoing suggests, the continuous use of the dominant boilerplate provisions by venture capitalists, even if they are not ideally suited to investors, could be viewed as a form of 'collective conservatism.' It may be argued that investors accept the suboptimal boilerplate provisions not because they believe that the standardized terms and conditions sufficiently align the interests of investors and managers, but merely because they think their peers, including the venture capitalists, prefer to include them in the limited partnership agreement. The often-ineffective '2 and 20' rule may persist for this reason. Yet the financial crisis has arguably led to deviations from the boilerplate provisions that are aimed at returning confidence in the venture capital industry. These deviations are discussed below.

3.1 Patching-up Revisions

The first strategy that is employed by venture capital fund managers to better attract institutional investors involves the inclusion of 'investor favorable' provisions in the limited partnership agreement (see Figure 4).[39] An example of such a provision is the scaling down of the management fee after the investment period is over, recognizing the declining workload of the general partners in the later stages of the fund's life. There are several variations to the scaling down formulas. Sometimes scaling down is achieved by using a lower management fee percentage after the investment period. In other cases venture capitalists propose to take a percentage of the invested capital – instead of the committed capital – after the investment period. We also see combinations of the two. As a rule of thumb, the average management fee is currently approximately 1.5% of the committed capital over a 10 years period.[40]

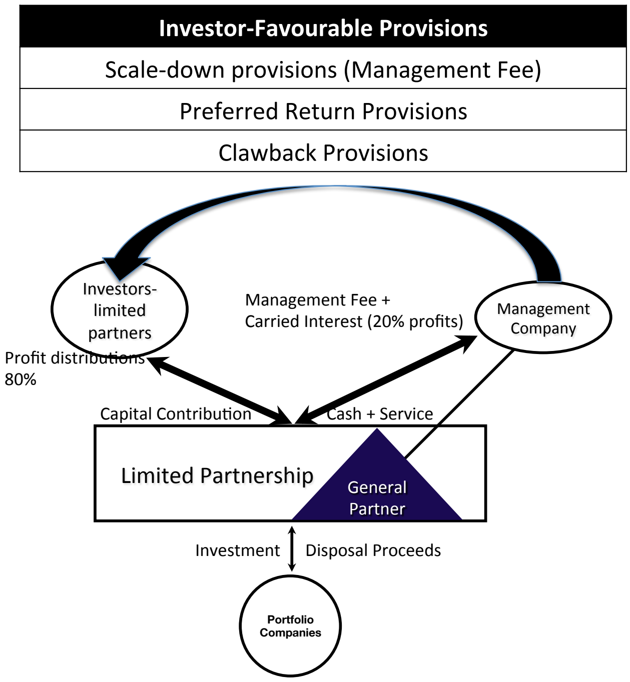
Another example is the increasing demand for restricted profit distribution arrangements, better known as 'waterfall' arrangements, in limited partnership agreements. Under these arrangements, the managers are only allowed to share in the profits after the investors have received a preferred return as stated in the limited partnership agreement. The question arises whether the inclusion of preferred return provisions effectively address the principal agent problems. Consider an agreement under which a carry is paid out at the occurrence of each exit and before a preferred return is

39 These 'patch-up provisions' are also included in the Institutional Limited Partners Association's Private Equity Principles (see www.ilpa.org).

40 See Brad Feld and Jason Mendelson, Venture Deals: Be Smarter than Your Lawyer and Venture Capitalist (Wiley & Sons Publications, March 2011),

provided to the investors. This may create perverse incentives to the managers to chase early carry distributions by pushing through profitable exits early in the fund's life. Crucially, if at a later stage it transpires that the general partners have received more than their fair share of the profits, investors will often be entitled to call upon the clawback provisions under which the managers have to pay back the excess carry distributed earlier. Empirical research shows, however, that clawback provisions are not easily enforced.

Figure 4: Typical Venture Capital Fund



In many respects, the more stringent terms regarding compensation and distribution of profits have 'only' masked – not solved – the principal agent problems. Surely the 'scale down' provisions have become more 'investor favorable,' but the management fee arrangements still have the potential to create perverse incentives for fund managers. Again, consider the emergence of more 'zombie funds.' If the management fee is linked to the actual invested capital – instead of the committed capital – managers have an incentive to overvalue a fund's nearly dead portfolio companies.[41] Also, according to a recent study, it would be a mistake to believe that the common preferred return provisions and subsequent catch-up provisions give adequate incentives to general partners to engage in long-term

41 If the investors contend the valuations, thorny and costly valuation discussions will follow.

thinking.[42] It shows that the common 'waterfall' provisions may still entail a trade-off between short-term compensation for the general partners versus long-term capital gains for the investors. Because general partners only start to share in the profits after the preferred return is met, they have an incentive to pursue quick exit strategies to ascertain early returns on investment. Obviously, the general partners are focused on reaching the catch-up period as quickly as possible, while the investors want to see the best – not necessarily the fastest – return on their investment.

In the next Section, we observe more dramatic revisions to the limited partnership arrangements, rejecting the belief that limited partnership agreements are able to deal effectively with the information and incentive problems that abound in the venture capital industry.

3.2 Shift in Control over Investment Decisions

The academic venture capital literature has emphasized that, in order to deal effectively with the principal agent problems, an increasing number of institutional investors seek a higher degree of control and flexibility over their capital commitments, thereby becoming more actively involved in the investment choices. For instance, in order to get around the obligation to passively make the capital contributions to a traditional fund when called upon by the general partners, institutional investors may look for fully customized investment solutions by entering into separate accounts arrangements. These arrangements are different from the organization of traditional funds in that an investor's capital contribution will only be invested in accordance with its specific investment strategies and interests. From the perspective of more 'active' limited partners the benefits are twofold. First, separate account arrangements are flexible in the sense that they are usually tailored to the investors' risk appetite and diversification needs. Second, it is obvious that arrangements between a single limited partner and a venture capital firm enable investors to bargain for better terms and conditions, including 'disruptive' and investor-favorable management fees and carried interest provisions. Furthermore, it is only to be expected that institutional investors will be more inclined to invest in separate accounts in the future. Confirming evidence shows that, even though only 7 out of 100 surveyed institutional investors have set up a separate account arrangement, 35% of the investors are seriously considering investing through a separate account arrangement in the future.[43] Apparently, these arrangements are most popular amongst fund investors with assets under management of up to US $5 billion, making up 79 percent of the 35 investors that reacted positively to the adoption of separate accounts provisions.

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42 See James Taylor, "Do waterfall provisions lead to conflicts of interest", Private Equity International, 9 August, 2012.
43 See Emma Dineen, "Changing Methods of Accessing Private Equity", Preqin Private Equity Spotlight, July 2012.

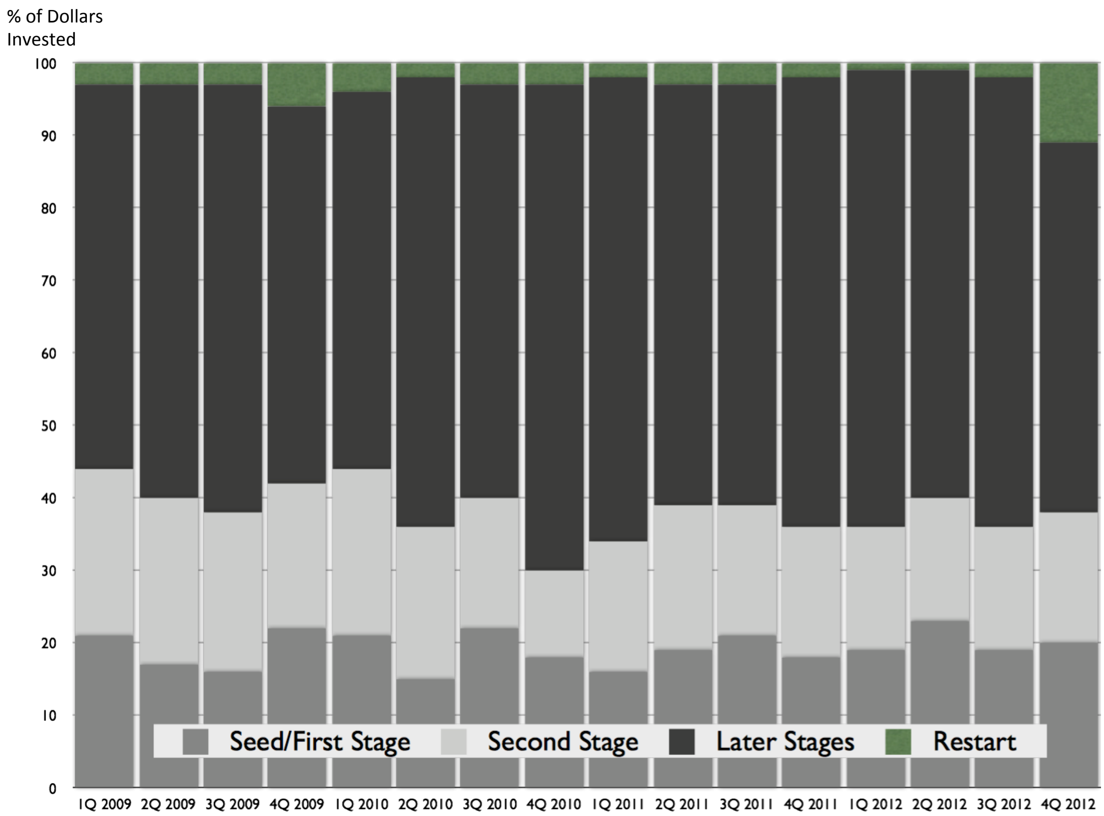
Innovative venture capitalists and investors have come up with even more sophisticated alternatives to deal with the incomplete limited partnership agreement dilemma by negotiating arrangements that allow them to make investment decisions on a deal-by-deal basis. Obviously, investors may decide to invest directly in venture capital opportunities. But the uncertainties and information asymmetries often deter institutional investors from investing directly in high growth companies. Yet, in an attempt to make investments in the best performing companies more lucrative, there is evidence of an increase in venture capital deals with institutional investors piggybacking on the due diligences and selection efforts of their fund managers by pursuing a co-investment strategy.[44] Indeed, recent studies show that co-investments gain in popularity. One of the studies even found that co-investment rights provisions are already a must-have for institutional investors.

Investors' search for greater control over both the investment decisions and the negotiations of the fund terms has also led to alternative fund structures, such as pledge funds.[45] Pledge funds offer investors the opportunity to make investment decisions on a deal-by-deal basis. To put it simply, a pledge fund is a combination of the best elements of a venture capital fund and a loose network of angel investors.[46] Similar to a venture capital fund, a pledge fund is typically managed by experienced venture capitalists or business angels, who are responsible for deal flow development, investment selection and portfolio management. The investors, however, have more discretion on whether to accept the fund managers' investment proposals. In order to get access to investment opportunities, the investors must usually pay an annual fee. Although admitted investors can review potential portfolio companies, they are often not obliged to participate in the deal. If the managers receive sufficient commitments from the 'member investors,' they can prepare and negotiate the deal documents on behalf of the fund – in most cases a separate limited partnership is set up to make the investment in the start-up company. The advantages are clear. Besides the greater control over portfolio acquisitions, the pledge fund alternative also gives investors the possibility to avoid high management fees and carried interest.[47] The downside is that pledge funds structures usually come with higher transaction costs. Moreover, it should be noted here that the direct involvement of

44 Co-investments alongside qualified venture capital funds are particularly gaining momentum in Canada. In the US, see also the example of Correlation Ventures, a venture capital firm that uses a co-investment model as well. See <http://correlationvc.com/> last accessed on 23 November 2012.
45 See Jonathan Blake and Liz Judd, ,"Fund Structures 2012", Bespoke Tailoring - Expert Commentary SJ Berwin, Private Equity International, April 2012.
46 See Jonathan Tower, "The Rise of the Pledge Fund," Adventure Capitalist Blog, 19 May 2008.
47 See GregoireGille, "Pledge Funds Not a Panacea, Says SJ Berwin's Sonya Pauls", Unquote, 18 April 2012.

institutional investors in early stage venture capital deals is still limited. They particularly look to gaining exposure to direct investments in the less risky later stage and private equity/buy-out deals.[48]

Figure 5: Investment Allocations in the United States (2009-2012)



Source: Dow Jones VentureSource

Our analysis leads to the conclusion that limited partners increasingly focus on expansion or later stage venture capital investments. If we look at funds that held their final close in the period 2010 to May 2012, we observe that 18 percent of them focus on later stage/expansion investments.[49] To be sure, the majority of the funds – 55 percent – adopt a multi-stage approach. But, due to the subdued fundraising environment, some of these more general funds also show a general propensity to

48 See also Preqin Special Report: Venture Capital, May 2012. The Report shows that the percentage of investors looking to target venture capital over the next twelve months has decreased significantly during the first half of 2012 (15%) compared to the first half of 2011 (28%). The interest of investors in small- to mid-market buyout funds remained steady (52 percent during the first half of 2011 and 49 percent during the first half of 2012.

[49] Data derived from Preqin Special Report: Venture Capital, May 2012.

finance later stage, lower-risk companies.[50] This trend is particularly visible in the United States (see Figure 5). In the context of later stage investments, where minimizing risk and maximizing financial return prevail, the venture capitalists attempt to gain a good reputation and outstanding track records. This observation is consistent with the 'survival of the fittest' finding. Still, as we have seen, the move to later stage investments will not immediately lead to significant changes in limited partnership agreements. What is even more worrisome is that the survival of the fittest trend will not bridge the funding gap in the seed and early stages in the venture capital cycle. We can only observe a gradual shift towards more investor-favorable limited partnership agreements.[51] The areas in which we have seen some marginal revisions are in the compensation, management fee and waterfall provisions. This question bears on whether we can expect to see more dramatic revisions to the fundraising process, readdressing the long-standing focus on principal agent problems (and at the same time making more early stage capital available). This question will be answered in the next Section.

4. Venture Capital Funds as Collaborative Agreements

Having seen how and when limited partnership agreements change, we now examine another strategy that venture capital fund managers can deploy that potentially allows them to bring more value to the traditional venture capital model. We start by asking how funds can improve and accelerate the fundraising processes.

While the contemporary pattern of fundraising is strongly linked with the level of fund returns and the expectation of exit through an initial public offering, funds could deliberately choose not to raise capital from anonymous risk-averse institutional investors. Rather a new wave of fundraising has emerged whereby funds handpick a dozen or so active investors for their specific individual qualities.[52] The rationale behind this new trend is the belief that a venture capital fund that is backed solely by passive investors is not sufficiently equipped to fertilize a promising and innovative idea. This accounts for why funds have started to recruit patient investors with different abilities and affinities.[53] Unlike a traditional venture capital fund, these funds often have as a unique feature that, at the request of the manager, fund investors could be actively involved in the investment process and due diligence activities, provide direct advice to start-up companies and assists directly in the

[50] See Pui-Wing Tam and Amir Efrati, "Web Start-Ups Get Upper Hand Over Investors: VC Firms Drive Up Valuations, Attach Fewer Strings to Deals", Wall Street Journal, 10 March, 2011.
[51] See also Preqin Investor Network, "Challenges Facing LPs Investing in Private Equity, Private Real Estate and Infrastructure", August 2012.
[52] See Drake Bennett, "The League of Extraordinarily Rich Gentlemen", BusinessWeek, 30 July 2012.
[53] See Evelyn M. Rusli, "In Flip-Flops and Jeans, An Unconventional Venture Capitalist", The New York Times (DealBook), 6 October 2011.

development of new technologies. Further, these funds, through the collaborative process, hope to build relationships that can lead to a joint development of new products for new markets, thereby creating value where it did not exist before.[54] Interestingly, a natural trend toward a more collaborative fundraising view will have a disruptive effect on the traditional – but often underperforming – traditional venture capital model.

To see this consider that these collaborative partnerships are organized in an egalitarian rather than a typical 'general partner – limited partner' fashion. The egalitarian structure manifests itself in the rejection of the typical organization between limited partners and general partners. Particularly, we see a dramatic change in the distribution and compensation arrangements. For instance, instead of the usual 1 percent, fund managers make considerably larger capital contributions than 'only' 1 percent of the committed capital.[55] Moreover, there are instances where the general and limited partners share equally in profits and losses. Fund managers are on a fixed salary arrangement, which is not linked to a percentage of the committed or invested capital. There is no carried interest. Since limited partners sometimes act as a kind of venture capitalists-on-demand, being more closely involved in investment decisions, the fixed management compensation structure is likely to be more effective compared to the incentive pay regime which we normally see in limited partnership agreements. Indeed, active and knowledgeable investors are in a better position to effectively and timely monitor fund management and investment decisions. Unlike the 'passive' institutional investors, they do not only have to rely on the contractual arrangements to help reduce principal-agent problems.

Do these arguments suggest that there are marked differences emerging in the fundraising environment, which have been remarkably stable over the last few decades? Given the venture capitalists' focus on institutional investors to make up their limited partner base, it would probably go too far to suggest here that we would see an immediate climate change in the negotiations of venture capital agreements. Yet the collaborative partnership structures could very well be viewed as the result of new trends in the global venture capital industry. In this respect, we point at the super angel funds or micro/boutique venture capital funds. These funds appeared in the mid-2000s. Moreover, we foresee an increase in the number of 'joint' venture capital funds in which strategic investors often act as an anchor investor. Particularly, multinational corporations (in their search for the 'next big thing') are altering their investment strategies from mere financial participations in

[54] See also Ronald J. Gilson, Charles F. Sabel and Robert E. Scott, Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration, Colombia Law Review, Vol. 109, 2009.
[55] See Christopher Witkowsky, Fundraising GP2 put more 'skin in the game', Private Equity International, 14 November 2012. Co-investing by managers – Wellington…

promising start-ups to more explorative and strategic investment modes, thereby entering into partnership-type relationships with both venture capital firms and emerging growth companies. In the following Sections, we will provide examples of venture capital funds which are characterized by their collaborative nature and focus on joint value creation. We will first discuss micro-venture capital funds and then turn to 'joint' venture capital funds.

4.1 Micro-Venture Capital Funds

Micro-venture capital funds (or super angel funds) are becoming more and more established in the venture capital industry.[56] In general, these funds are managed by former entrepreneurs. These managers usually contribute a significant amount of capital to their own fund, giving the other investors a feeling of being in it together.[57] But there is more, the micro-venture capital funds tend to pursue a 'partnership strategy' with their investors.[58] By doing so, they were able to attract other investing interests from friends, other angels, wealthy individuals and family offices that are often looking for highly innovative investment opportunities for their wealth.[59]

The collaborative synergy that emerged from these investment teams has attracted considerable interest from university endowments and other institutional investors.[60] Tables 1 and 2, which give an overview of the most notable micro-venture capital funds, show that these funds are currently able to secure capital commitments in the amount of $20 million to $100 million, an amount that is rapidly growing. Indeed, investing in the 'have-been' entrepreneurs is very appealing. Because they are extremely well connected in their former line of business, they are often better positioned than traditional venture capitalists to pick out winners, but also able to mentor them through the very early start-up phases, increasing the possibility of follow-on investments from 'traditional' venture capital funds and corporations.[61]

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[56] See Judith Messina, "'Super angels' come down to earth", Crain's New York Business, 5 September,2012.
[57] See Tomio Geron, "Angel investors get backers of their own", Wall Street Journal, 22 July, 2010.
[58] See Tom Kerr, "Super Angels Give VCs a Run for Their Money", Venture Hype, 1 September, 2010.
[59] See Brad Feld and Jason Mendelson, Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist (Wiley& Sons Publications, March 2011).
[60] See "VC 'Super Angels': Filling a Funding Gap or Killing 'The Next Google'?", The Wharton School, 1 September, 2010, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2580> last accessed on 23 November 2012.
[61] It is therefore not surprising that reputed, well-established venture capital firms are willing to welcome these 'have-been' entrepreneurs as partners. For instance, former founders of LinkedIn, Reid Hoffman and Konstantin Guericke, are currently partners in US Greylock Partners and German EarlyBird, respectively.

Table 1: Micro Venture Capital Funds in the United States

The United States					
Name	**Experience**	**Firm Name**	**Latest Fund Size ($M)**	**Deal Experience**	**Notable Investments**
Peter Thiel	Paypal (co-founder), Facebook (first outside investor)	Founders Fund	Founders Fund IV (2012) ($625) Founders Fund III (2010) ($250)	65	Facebook, Spotify, SpaceX, Yammer
Ron Conway	PTS, Altos Computers	SV Angel	SV Angel IV ($40)	176	Google, Paypal, Facebook
Jeff Clavier	Reuters Executive	SoftTech VC	SoftTech VC III (2011) ($55)	59	Mint, Userplane, Kaboodle
Michael Dearing	eBay, Stanford Professor	Harrison Metal	Unspecified	33	Aardvark, admob, DocVerse
Dave McClure	Paypal	500 Startups	500 Startups I (2011) ($29)	187	SlideShare, Mint
Aydin Senkut	Google	Felicis Ventures	Felicis Ventures III (2012) ($70.50) Felicis Ventures II (2010)($40)	68	Mint, Tapulous, Disqus
Mike Maples	Motive, Inc.	Floodgate	Floodgate Fund IV (2012)($75) Floodgate Fund III (2010)($73.50)	77	Twitter, Digg
Bill Trenchard (and others)	Callcast	Founder Collective	Founder Collective II (2012)($70)	91	Minyanville Media
Chris DeVore	Judy's Book	Founders Co-Op	Founders Co-Op II (2012)($8)	23	
Roger Ehrenberg	Kinetic Trading Strategies	IA Ventures	IA Venture Strategies Fund II (2012)($105) IA Venture Strategies Fund I (2010)($50)	40	Recorded Future
Manu Kumar	SneakerLabs, Inc.	K9 Ventures	K9 Ventures II (2012)($40) K9 Ventures (2010)($6.3)	14	CrowdFlower
Kenneth Lerer	AOL, Huffington Post	Lerer Ventures	Lerer Ventures II (2011)($25) Lerer Media Ventures (2009)($8.5)	96	GDGT
Chris Sacca	Google	Lowercase Capital	Lowercase Venture Fund I (2010)($8.5)	30	Twitter
Joshua Kushner	UniThrive, (son of real estate magnate Charles Kushner)	Thrive Capital	Thrive Capital Partners III (2012) ($150) Thrive Capital Partners II (2011) ($40) Thrive Capital Partners I (2009) ($10)	24	Hot Potato

Source: Data from Business Insider – Who Are The Super Angels? A Comprehensive Guide, 4 October 2010, The 25 tech angels, 11 good angels, and 18 geeks everyone wants to fly with, San Francisco Magazine, December 2010, Preqin – Venture Deals Analyst, Websites of the respective funds

Table 2: Micro Venture Capital Funds in Europe

Europe				
Name Experience	**Firm Name**	**Latest Fund Size**	**Deal Experience**	**Country**
Robin Klein (Innovations) & Saul Klein (Lovefilm Int., Skype)	The Accelerator Group (TAG)	Unspecified	42 (in 2010)	United Kingdom
Julie Meyer (First Tuesday)	ACE (Ariadne Capital Entrepreneurs Fund	$32 million	Unspecified	United Kingdom
Niklas Zennström (Skype, Kazaa)	Atomico	Atomico Ventures II - $122 million	41	United Kingdom
Rogan Angelini-Hurll (Citi Pan European Media Research, Salomon Brothers) & Sean Seton-Rogers (Balderton Capital, Commonwealth Capital Ventures)	PROfounders Capital	$42 million	10	United Kingdom

Stefan Glaenzer (Last.fm), Eileen Burbidge (Ambient Sound Investments) & Robert Dighero (AOL)	Passion Capital	$60 million	12	United Kingdom
Jos White & Ben White (Star, Messagelabs)	Notion Capital	Notion Capital 2 (2010) - $112 million Notion Capital - $40 million	13	United Kingdom
Xavier Neil (ISP lliad) & Jérémie Berrebi (Net2One)	Kima Ventures	$15 million	27	France
Pierre Kosciusko-Morizet (PriceMinister), Geoffroy Roux de Bezieux (Virgin Mobile), Stéphane Treppoz (Sarenza) & Ouriel Ohayon (ex TechCrunch.fr)	ISAI	ISAI Fund I - $45 million	9	France
Marc Simoncini (iFrance and Meetic)	Jaina Capital	Unspecified	11	France
Alexander, Marc & Oliver Samwer (Alando, Jamba)	European Founders Fund	Unspecified	16	Germany
Lars Hinrichs (XING)	HackFwd	Unspecified	7	Germany

Source: Datafrom Stuart Derrick, 14 Super Angel investment funds operating in the UK revealed, Growing Business, Preqin – Venture Deals Analyst, Websites of the respective funds

4.2 Joint Venture Capital Funds

There has been growing interest in joint venture capital funds. A good illustration of a 'joint' venture capital fund is the partnership between First Green Partners, a new early-stage venture capital firm, and Warburg Pincus LLC, a leading global private equity firm. In the 'joint venture,' Warburg Pincus is an anchor investor with a capital commitment of $355 million. Warburg Pincus' expertise in the energy industry and its network in conventional and unconventional energy is perhaps an even more valuable tool to First Green's investments in applications of clean and green technologies.[62] And there are more examples. Consider the Silicon Valley venture capital firm Redpointe.ventures, which was jointly created by two other Silicon Valley pioneers Redpoint Ventures and e.ventures in July 2012.[63] The fund, mainly backed by the joint venturers and their investors, had raised $130 million for investments in early-stage Internet start-ups in Brazil. Similar to the micro-venture capital funds, there are relatively few barriers to create these joint initiatives or to attract the interest of other investors. For instance, Germany-based mail order company Otto Group, which is also a long-time investor in e.ventures, has committed $20 million to Redpointe.ventures. The US networking equipment company Cisco is another investor with a commitment of $15 million.[64]

Currently, corporations play a dominant role as anchor investors in these 'joint' venture capital funds. They are reliable in the sense that they are able to contribute their committed capital investments. Moreover, corporations can actively contribute to the reputation of a venture capital fund. In fact, corporate investors optimally facilitate the development of fruitful and lasting collaborations,

[62]See Global Corporate Venturing, Warburg Pincus backs new VC, January 2012.
[63] See Sarah McBride, "Redpointe.ventures raises $130 million fund for Brazil", Reuters,23 July 2012; VinodSreeharsha, "Venture Capital Firm Makes Long-Term Bet on Brazil", New York Times (DealBook), 23 July 2012; TomioGeron, "RedpointE.Ventures Raises $130 Million Brazil VC Fund",Forbes, 23 July, 2012; Richard Waters, "US fund to back Brazil tech start-ups", Financial Times, 23 July, 2012.
[64] See Toby Lewis, "Redpointe.Ventures raises $130m", Global Corporate Venturing, 25 July 2012.

signaling a quality fund in which other investors, such as family offices, have ample incentives to commit to the funds' strategy and investment decisions. But there is more to attracting corporate investors than their capital contributions and reputation. Corporations often contribute knowledge, investment opportunities and deal flow. Moreover, at the request of the venture capital fund managers, corporations could participate in the due diligence processes of potential investment targets, offer technical and marketing advice to portfolio companies and assist them in the development of the new technologies. Hence, they could increase the exit opportunities for venture capitalists, by acting as a potential buyer in an eventual trade sale of a portfolio company that proves to be strategically interesting. Finally, the transition to working closely with corporations could create other investment options, including participation in the corporation's spin-out or spin-off companies.

Not only does the relationship between corporate investors and venture capital fund managers have implications for the fund industry, it also offers a wide array of advantages to the corporations. For instance, setting up a partnership with venture capitalists provides the corporations with a window to the market, helping them to find the 'next big thing' in other companies/markets. Moreover, the partnering arrangements are often designed to accelerate a corporation's innovation cycle or to assist in its efforts to expand its technological position to emerging markets. Here it should be noted that the human factor plays a pivotal role in the success of the joint venture capital fund. Corporations often allow staff members – either through relocation to the fund or secondment – to liaise between the fund and the corporation's venture capital and research and development departments. Clear rules on conflicts of interest are of course a key element in structuring the liaison's position. In previous work, the authors already gave examples of the possible relationships between venture capital fund managers and corporate investors. Table 3 contains an overview of deals that were concluded in the first half of 2012.

If we see a more strategic involvement of corporations in venture capital funds, the question is what the impact of this will be on venture capital fund agreements. In contrast to the 'traditional' venture capital fund agreement, which, as we have seen, mainly sets out conditions for investing, capital contributions, and compensation and distribution requirements, an agreement with a corporate anchor investor must govern three relationships: (1) the relationship between the venture capitalist and the corporation, as a strategic investor, (2) the relationship between the venture capitalist and other strategic and/or financial investors, and (3) the relationship between the strategic and financial investors in the venture capital fund. However, given the focus on the principal agent problems, it should come as no surprise that a positive correlation exists between the demand and use of contractual control restrictions and the propensity of the venture capitalist and one or more of its strategic anchor investors to behave opportunistically. As it turns out, it comes as no surprise that when the venture capitalist raises funds from a strategic anchor investor, the traditional financial investors will bargain for more restrictions and covenants relating to the management of the fund, conflict of interests, and restrictions on the type of investments the fund can make. The restrictive nature of covenants, which must make sure that all investors are treated equally, will come as a 'natural' reaction to the uncertainty, information asymmetry and agency costs resulting from the strategic investor's participation. Still, as was already mentioned, the use of restrictive covenants can entail inefficiencies and the erosion of value from the partnership, as they restrict the venture capitalists' ability to benefit from the knowledge, resources and investment opportunities of the strategic corporate investor.

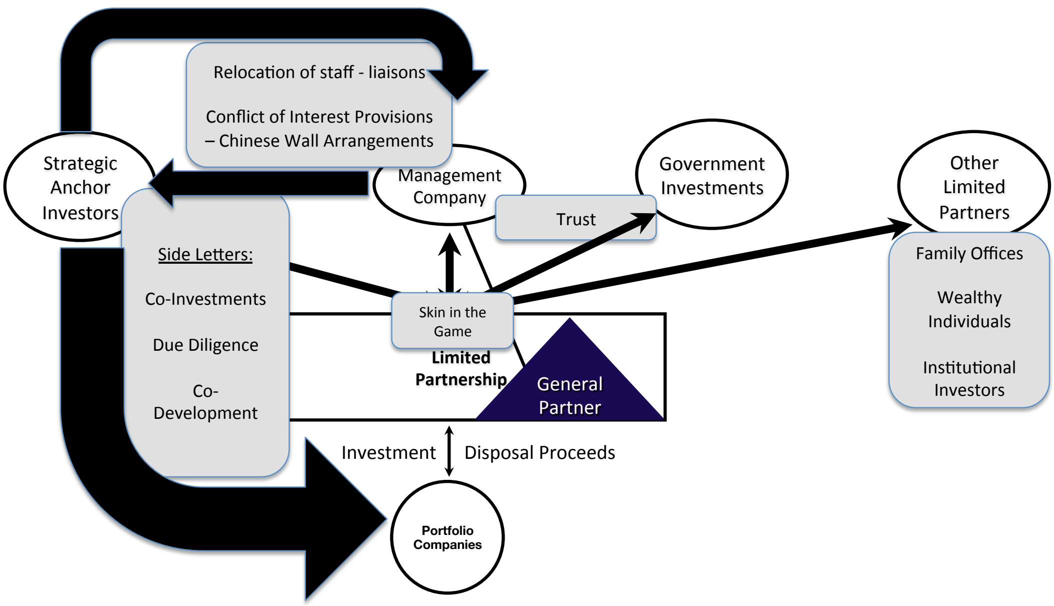
Note that it is common practice that corporations, in conjunction with the venture capitalist, endeavor to obtain more favorable terms than other investors with respect to management fees, deal flows, portfolio selection and monitoring, investment decisions, and co-investment rights. These more favorable terms – that deviate from the underlying limited partnership agreement – are set out in side letters or side agreements. The reputation of both the venture capitalists and the corporation – as a strategic investor – will, of course, affect the other investors' willingness to accept the side letters for one of their co-investors in the fund. If institutional investors, family offices and other investors have difficulties in accepting the more-favorable deal terms for the strategic corporate investor, the venture capitalists and corporations are left with three options.

The first of these options is for the corporate investor to take a position as sponsor and only anchor investor in a venture capital fund. The second option is to find government sponsorship. When incentives are ill aligned – as could be the case if a strategic anchor investor enters the scene – it is arguably appropriate for venture capitalists to have governments making fund investments in an attempt to restore the balance of interests among the other strategic and financial investors. Government investments pursue two main goals: (1) they signal the trustworthiness of venture capital initiatives, and (2) their more long-term and patient investment strategy facilitates the development of fruitful and lasting 'partnerships' among the strategic corporate investors and other private investors.

The third option is that the venture capitalist will set up a partnership with two or more corporate investors that are willing to join forces in an investment fund that targets high-potential growth companies and/or other innovative projects. Table 3 already shows several examples. In March 2012, France Telecom Orange and Publicis Groupe decided to work together with Iris Capital in three funds with a different scope: (1) OP Ventures Growth with a focus on established companies in France and Europe, (2) OP Ventures Global with a restricted scope on start-up companies outside Europe, and

(3) OP Ventures Early Stage that intends to provide seed and early-stage capital to start-up companies in Europe. Another example is the partnership between Index Ventures and two competing pharmaceutical companies, GlaxoSmithKline and Johnson & Johnson. The €150 million fund mainly invests in single assets that have the potential to become leading products in the future, the so-called asset-centric investment model. The corporate investors provide advice to Index Ventures by appointing their representatives on a scientific advisory committee. In order to avoid potential conflicts of interest, however, the two multinationals have not obtained any preferential rights (of first refusal) to promising drugs that could emerge from this partnership. If they are interested in acquiring an 'asset,' they will have to engage in an open competitive bidding process.[65] Index Ventures hopes through a supportive, but at the same time independent attitude of its corporate investors to develop a partnership that can lead to a joint development of new drugs and medicines.

Figure 6: Joint Venture Capital Funds



[65] See Andrew Jack, GSK and J&J launch €150m fund with Index, Financial Times, 21 March 2012. See also Kristen Hallam, Glaxo Joins J&J in $200 Million Fund With Index Ventures, Bloomberg BusinessWeek, 21 March 2012.

What does this all say about the new institutional arrangements that have emerged in structuring partnerships? In our argument, it is clear that, besides proposing the traditional (or more investor-favorable) provisions in a limited partnership agreement, managers have several other strategies when structuring a future venture capital fund. Venture capitalists can take a real partnership-type approach by setting up a new fund in which investors are selected on the basis of particular abilities and affinities – and the venture capitalists contribute a significant amount to the fund themselves (see Figure 6). The fundraising successes of micro-venture capital funds and joint venture capital funds provide illustrations of this partnering strategy. If venture capitalists are willing to adopt new fundraising strategies – and fortunately we see this already happening – we predict that they will continue to play a pivotal role in fostering innovation and entrepreneurship across Europe, the United States and globally. It is important to underscore that they can use any combination of the above-referred strategies when setting up a new fund, and that there may be additional strategies not mentioned in this paper that motivate the organization and structure of venture capital funds.

Table 7: Corporate Venture Capital Investments in Venture Capital Funds (First Half 2012)

Name Corporate Investor	Name VC Fund Manager	Name VC Fund	Amount of Investment	Fund's Total (Targeted) Committed Capital	Fund's Scope - Sector	Fund's Scope - Geography
Softbank China Venture Capital (Softbank)	Southern Cross Venture Partners	Southern Cross Renewable Energy Fund	$100 mln	$200 mln	Renewable Energies	Australia
Warrants Capital (Silver Ridge) and others	Huatai Financial Holdings (Hong Kong)	Huatai Von Malaysia Fund	$5 mln	$500 mln	Commodities & Natural Resources	Asia
Cisco	Riyada Enterprise Development (Abraaj Group)	Lebanon Growth Capital Fund	$7 mln	$30 mln	Mixed	Lebanon
Edenred	Partech International	Partech International VI	$20 mln	$129.5 mln	E-commerce, digital media & infrastructure technology	Europe and Silicon Valley (US)
Bertelsmann AG	University Ventures	University Ventures Fund	$51.8 mln	$100 mln	Higher Education	Europe and US
Point B	Correlation Ventures	Correlation Ventures	Unspecified	$165 mln	Mixed	US
Mahindra Satyam	SBI Holdings	Unspecified	$25 mln	$50 mln	ICT	Global
KDDI	Global Brain	KDDI Open Innovation Fund	$65 mln	$65 mln	IT	Japan, Global
France Télécom-Orange, Publicis Groupe	Iris Capital Management	OP Ventures Growth, OP Ventures Global and OP Ventures Early Stage	$194.5 mln (in aggregate)	$389 mln	IT, ICT, Digital Media	France and Europe (OP Ventures Growth and Early Stage); Global (OP Ventures Global)
Overseas Private Investment Corp. - OPIC (US Government)	TPG	TPG Alternative & Renewable Technologies Partners	$125 mln	$500 mln	Clean-tech	Global (focus on Latin America and Southeast Asia)

RIM, Corus Entertainment, Thomson Reuters	Relay Ventures	BlackBerry Partners Fund II	Unspecified	$150 mln	Mobile Computing	North America (US, Canada)
Jonhson & Johnson, GlaxoSmithKline	Index Ventures	Index Life VI	$100 mln (in aggregate)	$200 mln	Healthcare	Europe and US
Johnson Controls	Nth Power	Unspecified	Unspecified	$200 mln	Unspecified	Unspecified
Lenovo	Vertex Venture Capital	Vertex IV Fund	Unspecified	$200 mln	Broadband communications, digital media and IT	Israel
Evonik Industries	High-Tech Gründerfonds	High-Tech Gründerfonds II	$3 mln	$376.8 mln	Mixed	Germany
Goldman Sachs	Core Innovation Capital	Core Innovation Capital I, L.P.	Unspecified	$45 mln	Financial Services	US
Merck	Lumira Capital	Merck Lumira Biosciences Fund (Quebec), L.P.	$35 mln	$50 mln	Life Sciences	Québec, Canada
GroupeArnault	L Capital Management	L Capital 3 FCPR	Unspecified	$535 mln	Life Style and Retail	Europe
Essent, Delta	Chrysalix SET	SET Fund II C.V.	$13 mln (in aggregate)	$130 mln	Sustainable Energy Technologies	Europe
Merck Research Ventures Fund (Merck)	Flagship Ventures	Flagship Ventures Fund IV L.P.	Unspecified	$270 mln	Life Sciences	US
RIM and others	Communitech	HYPERDRIVE	$30 mln	$30 mln	Incubator	Kitchener-Waterloo area, Canada
BP Ventures, Indian Government	INFUSE Capital	INFUSE Capital Fund	$9 mln	$25 mln	Clean-tech	India
Shui On Group	InnoSpring	InnoSpring Seed Fund	Unspecified	Unspecified	Incubator	US and China
Cathay Financial Group, CID and others	appWorks Ventures	appWorks Fund I	Unspecified	$10.2 mln	App Design	Taiwan
BBVA	500 Startups	500 Startups Seed Fund	Unspecified	Unspecified	Accelerator	Silicon Valley, US
Asahi Glass Company, Mitsubishi Chemicals, JSR Corporation and others	Pangaea Ventures	Pangaea Ventures Fund III, L.P.	$50 mln	$100 mln	Advanced Materials	North America, Europe and Russia
BASF Venture Capital (BASF)	Tsing Capital Venture Capital Management Co. Ltd.	China Environment Fund (CEF) IV, L.P.	$5 mln	$350 mln	Clean-tech	China
Eli Lilly	BioCrossroads	Indiana Seed Fund II	Unspecified	$8.25 mln	Life Sciences	Indiana, US
American Electric Power	Braemar Energy Ventures	Braemar Energy Ventures III, L.P.	Unspecified	$300 mln	Clean-tech	Unspecified
Eli Lilly	TVM	TVM Life Science Ventures VII	$40 mln	$150 mln	Life Sciences	Québec, Canada
SBI Holdings, FMO (Dutch Development Agency)	SBI Ven Capital	SBI-FMO Emerging Asian Financial Services Fund	$51 mln (in aggregate)	$80 mln	Financial Services	Asia

Source: Data from GlobalCorporateVenturing

5. Conclusion

In this paper, we present an analysis of legal boilerplate provisions in limited partnership agreements by focusing on the terms designed to reduce agency costs by aligning the incentives of the general partner with the interests of limited partners. Consistent with the literature on institutional behavior, we find that the continuous use of boilerplate provisions is a form of 'collective conservatism'. We argue that these results help explain why venture capitalists typically maintain using suboptimal boilerplate provisions. Venture capitalists may be hesitant to abandon these provisions out of concern that their peers and major rivals prefer to use them in their partnership agreements. This suggests that often-ineffective '2 and 20' rule may persist for this reason. There is evidence in this paper that points to deviations from the boilerplate provisions that are aimed at returning confidence in the venture capital industry. According to this view, we observe a gradual shift towards more investor-favorable limited partnership agreements or separate accounts and pledge funds arrangements. Put differently, these strategies - which do not lead to significant changes in the limited partnership agreements - appear to be particularly effective for bigger funds that increasingly focus on later stage investments.

However, this paper shows that particularly early-stage funds are more inclined to enter into innovative collaborative agreements. While the contemporary pattern of fundraising is strongly linked with the level of fund returns and the expectation of profitable exits, some funds deliberately choose not to raise capital from anonymous risk-averse institutional investors. Rather the evidence points to a new wave of fundraising emerging, whereby funds handpick active and patient strategic investors for their specific individual qualities. Furthermore, unlike traditional partnership agreements, these collaborative arrangements acknowledge that the use of restrictive covenants, to curtail potential principal agent problems, can entail inefficiencies and the erosion of value from the partnership, as they restrict the venture capitalists' ability to benefit from the knowledge, resources and investment opportunities offered by strategic investors. We find that these collaborative agreements are based on trust, joint development and value creation, which provide a constructive strategy for developing alternative institutions arrangements in the venture capital industry.

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