VENTURE CAPITAL and PRIVATE EQUITY CONTRACTING

An International Perspective

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For
Sasha Adeline
and
Dylan Jedi

Preface

This book is intended for advanced undergraduate and graduate students in business, economics, law, and management. It is also directed at practitioners with an interest in the venture capital and private equity industries, and it covers several different countries. The definitions of the terms *venture capital* and *private equity* may differ among countries, however, so in the book we define *venture capital* as risk capital for small private entrepreneurial firms and *private equity* as encompassing a broader array of investors, entrepreneurial firms, and transactions, including later-stage investments, turnaround investments, and buyout transactions.

Financial contracting is the common theme that links the topics covered in this book. This book explains the ways these contracts differ across the many types of venture capital and private equity funds, types of institutional investors, types of entrepreneurial firms, and across countries and over time. We will see when and how financial contracts are pertinent to the allocation of risks, incentives, and rewards for investors and investees alike. This book also examines when and how financial contracts have a significant relationship with actual investment outcomes and successes.

Why should we care about financial contracting? Venture capital and private equity funds are financial intermediaries between sources of capital and entrepreneurial firms. Sources of capital typically include large institutional investors, including pension funds, banks, insurance companies, and endowments. These and other sources of capital do not have the time or expertise to invest directly in entrepreneurial firms, particularly high-growth firms in high-tech industries. As such, specialized venture capital and private equity funds facilitate the investment process—at a price, of course. These funds are for all intents and purposes organizations that are established, capitalized, and operated under specific contractual terms and obligations agreed between the investors and the venture capital and private equity funds. A different type of financial contract governs the relationship between venture capital and private equity funds and their investee entrepreneurial firms, how such firms are capitalized, and how they are in turn operated. It is obvious therefore that financial contracting is not only something that venture capital and private equity funds do, but it is also in essence what they are.

Broadly framed questions addressed in this book include, but are not limited to, the following:

- What covenants and compensation terms are used in limited partnership contracts?
- In what ways are limited partnership contracts related to market conditions and fund manager characteristics, and how do these contracts differ across countries?

- What are the cash flow and control rights that are typically assigned in venture capital and private equity contracts with investee firms, and when do fund managers demand more contractual rights?
- Do different contractual rights assigned to different parties influence the effort provided by the investor(s)?
- In what ways are different financial contracts related to the success of venture capital and private equity investments?

By considering venture capital and private equity contracting in an international setting, this book offers an understanding of why venture capital and private equity markets differ with respect to fund governance, investee firm governance, and investee firm performance. This book provides examples of actual contracts that have been used in practice, including a limited partnership agreement, a term sheet, a shareholder agreement, and a subscription agreement. In addition, we provide datasets of venture capital and private equity that include details on a large number of actual contracts. It is important and relevant to review data to distinguish real investment contracts from actual transactions and to explain how financial contracts are central to actual investment decisions and investment outcomes. Without analyzing data, we would at best be limited to our best guesses, which is not our intention. The data considered in this book are international in scope from over 40 countries, with a focus on Canada, Europe, and the United States. It is important to consider data from a multitude of countries to understand how and why venture capital and private equity markets differ around the world. Also, idiosyncratic features of certain countries may distort our understanding of how venture capital and private equity contracts work in practice.

In short, by considering international datasets and not data from only one country, we can gain significant insight into how venture capital and private equity funds operate in relation to their legal and institutional environment. Each chapter in this book, where possible and appropriate, refers to and analyzes data. It is important to keep in mind, however, that venture capital and private equity funds are not compelled to publicly report data, nor are they willing to do so. As such, there are always more data to be collected. This book provides an understanding of how venture capital and private equity funds operate through financial contracts and, it is hoped, will inspire further empirical work in the field so we may better understand the nature and evolution of venture capital and private equity markets in years to come.

A Brief Note on Organization and Data

Part I of this book consists of three chapters. Chapter 1 briefly discusses aggregate industry statistics on venture capital and private equity markets around the world to compare the size of the markets in different countries. Chapter 2 describes agency problems in venture capital and private equity investment and is the only chapter that does not consider data. The intention in Chapter 2 is to provide a framework for understanding various agency problems that are empirically studied in subsequent chapters. Chapter 3 provides an overview of the empirical methods considered in this book. The description of the statistical and econometric techniques used is intended to be user friendly so all readers can follow along each of the chapters regardless of background. Chapter 3 also provides an overview of the institutional and legal settings in the countries considered in the different chapters. A central theme in this book is that differences in venture capital and private equity markets, including but not limited to contracting practices, are attributable to international differences in legal and institutional settings.

Part II (Chapters 4–9) considers venture capital and private equity fundraising and the structure of limited partnerships. Public policy toward fundraising and fund structure are also discussed in Chapter 9. To understand the contractual structure of limited partnerships, this book does not focus exclusively on contracts but rather, by presenting evidence on motivations underlying institutional investment in venture capital and private equity, provides a context through which to understand contracts. Chapter 4 begins with the perspective of institutional investors to reveal the motivations underlying the source of capital: institutional investors. In the United States, many institutional investors have long-standing relationships with venture capital and private equity fund managers that span multiple decades. Internationally, institutional investors have comparatively less experience with investment. Chapters 4, 7, and 8 examine recent data from institutional investors from the Netherlands to study a market that although less developed than that of the United States has significant commitments to venture capital and private equity funds, commitments to funds both domestic and international, and commitments in niche areas such as the socially responsible investment class. Also, regulatory changes make the Netherlands particularly interesting to study from the perspective of institutional investors. Chapters 5 and 6 complement the analysis of data from institutional investors by providing data from venture capital and private equity funds from a multitude of countries (Belgium, Brazil, Canada, Cayman Islands, Finland, Germany, Italy, Luxembourg, Malaysia, Netherlands Antilles, the Netherlands, New Zealand, Philippines, South Africa, Switzerland, the United Kingdom, and the United States). This international comparative evidence highlights the role of legal and institutional differences around the world and the impact on fund governance. Likewise, the data introduced in Chapter 9 on the role of government are examined in several different countries.

While Part II focuses on fund structure and governance, the subsequent sections of this book highlight the role of financial contracts with entrepreneurs (Part III), governance provided to investees (Part IV), and the divestment process (Part V).

Part III (Chapters 10–14) covers material pertaining to financial contracting with entrepreneurs. Chapter 10 summarizes evidence on investment activities in a number of studies from the United States. Chapters 11–13 consider evidence from financial contracting from U.S. and Canadian VCs, with a focus on security design. Chapter 14 considers evidence on financial contracting from Europe. It is worthwhile to compare evidence on financial contracts from the United States, Canada, and Europe to understand how laws and regulations, among other things, influence the design of financial contracts.

Part IV (Chapters 15–18) relates financial contracts and other investment mechanisms to the governance provided to the investee firm. Chapter 15 provides a survey of numerous factors that might influence investee governance. Chapter 16 considers the relation between contracts and actual investor effort in terms of advice and monitoring, as well as disagreement between investors and investees. Chapters 17 and 18 consider noncontractual factors that influence investor effort, particularly the role of geographic proximity and portfolio size.

Part V (Chapters 19–22) studies the exit outcomes of venture capital and private equity–backed companies. Because investees typically do not have cash flows to pay interest on debt or dividends on equity, venture capital and private equity investors invest with a view toward capital gains in an exit event. Chapter 19 provides an overview of the exit decision and summarizes evidence on exits from Australasia, Canada, Europe, and the United States. Chapters 20 and 21 show how exits are significantly related to the governance of the fund (as considered in Chapters 4–9) and contracts between investors and investees (as considered in Chapters 10–14) and the effort provided (Chapters 15–18). Exit outcomes are considered with reference to extensive data from Canada (Chapter 20) and Europe (Chapter 21). Chapter 22 provides evidence on the financial returns to venture capital investment from 39 countries around the world from North and South America, Europe, Africa, and Australasia. The data indicate that financial structures and governance are significantly related to returns. Chapter 22 also discusses evidence on reporting biases of the performance of unexited institutional investors for companies that have not yet had an exit event.

Selected chapters in this book are based on the following previously published materials:

Chapter 5:
Cumming, D., and S.A. Johan, 2006. "Is It the Law or the Lawyers? Investment Covenants Around the World." *European Financial Management*, 12, 553–574.

Chapter 6:
Cumming, D., and S.A. Johan, 2009. "Legality and Venture Capital Fund Manager Compensation." *Venture Capital: An International Journal of Entrepreneurial Finance*, forthcoming.

Chapter 7:
Cumming, D., and S.A. Johan, 2007. "Regulatory Harmonization and the Development of Private Equity Markets." *Journal of Banking and Finance*, 31, 3218–3250.

Chapter 8:
Cumming, D., and S.A. Johan, 2007. "Socially Responsible Institutional Investment in Private Equity." *Journal of Business Ethics*, 75, 395–416.

Chapter 9:
Cumming, D., 2007. "Government Policy towards Entrepreneurial Finance in Canada: Proposals to Move from Labour Sponsored Venture Capital Corporations to More Effective Public Policy." *CD Howe Institute Commentary*, No. 247.

Chapter 11:
Cumming, D., 2005. "Agency Costs, Institutions, Learning and Taxation in Venture Capital Contracting." *Journal of Business Venturing*, 20, 573–622.

Chapter 12:
Cumming, D., 2006. "Adverse Selection and Capital Structure: Evidence from Venture Capital." *Entrepreneurship Theory and Practice*, 30, 155–184.

Chapter 13:
Cumming, D., 2006. "Corporate Venture Capital Contracts." *Journal of Alternative Investments*, Winter 2006, 40–53.

Chapter 14:
Cumming, D., and S.A. Johan, 2008. "Preplanned Exit Strategies in Venture Capital." *European Economic Review*, 52, 1209–1241.

Chapter 16:
Cumming, D., and S.A. Johan, 2007. "Advice and Monitoring in Venture Capital Finance." *Financial Markets and Portfolio Management*, 21, 3–43.

Chapter 17:
Cumming, D., and S.A. Johan, 2006. "Provincial Preferences in Private Equity." *Financial Markets and Portfolio Management*, 20, 369–398.

Chapter 18:
Cumming, D., 2006. "The Determinants of Venture Capital Portfolio Size: Empirical Evidence." *Journal of Business*, 79, 1083–1126.

Chapter 20:
Cumming, D., and S.A. Johan, 2008. "Information Asymmetries, Agency Costs and Venture Capital Exit Outcomes." *Venture Capital: An International Journal of Entrepreneurial Finance*, 10, 197–231.

Chapter 21:
Cumming, D., 2008. "Contracts and Exits in Venture Capital Finance." *Review of Financial Studies*, 21, 1947–1982.

Each chapter of this book begins with a list of learning objectives and ends with a list of key terms and discussion questions. PowerPoint lecture slides for each chapter are available on the Web at http://venturecapitalprivateequitycontracting.com. Any comments or questions about the book can be sent to the authors by e-mail at *Douglas.Cumming@gmail.com* and *sofiajohan@email.com*.

Contents

Part One

Introduction

1 Introduction and Overview

These days almost everyone has heard of the terms *venture capital* and *private equity*. The venture capital and private equity markets are frequently discussed in popular media and are often described as "scorching" in the popular press, at least in boom times. The market has direct relevance for entrepreneurs who want to raise money, investors who want to make money from financing entrepreneurs, and individuals who want to work for a fund or set up their own fund. Also, venture capital and private equity are of significant interest to the public sector, as government bodies around the world strive to find ways to promote entrepreneurship and entrepreneurial finance. It is widely believed that venture capital and private equity funds facilitate more innovative activities and thereby improve the well-being of nations. It is thought of as a critical aspect of national growth in the twenty-first century.

The 23 chapters of this book provide an analysis of the issues that venture capital and private equity market participants face during the fundraising process (Part II), investment process (Part III), and divestment process (Part IV). A common theme across all of these issues is agency costs, so agency theory is reviewed in Chapter 2. All of the issues addressed in this book are analyzed from an empirical law and finance perspective, with a focus on financial contracting. Financial contracts are central to the establishment of the relationship between venture capital and private equity funds and their investors. Financial contracts also govern the relationship between venture capital and private equity funds and their investee entrepreneurial firms, as well as determine the efficacy of the divestment process. In most chapters we refer to datasets to grasp the real-world aspects of the venture capital and private equity process. Further, it is important to consider international evidence to grasp the impact of laws and institutions on the respective venture capital and private equity markets. The empirical methods and legal and institutional settings in this book are overviewed in Chapter 3.

1.1 What Are Venture Capital and Private Equity?

At the outset, it is important to discuss the definitions of the terms *venture capital* and *private equity*. Venture capital and private equity funds are financial intermediaries between sources of funds (typically institutional investors) and high-growth and high-tech entrepreneurial firms. Funds are typically established as limited partnerships, but, as we will see, there are other types of funds. A limited partnership is in essence a contract between institutional investors who become limited partners (pension funds, banks, life insurance companies, and endowments who have rights as partners but trade "management" rights over the fund for limited liability) and the fund manager, who is designated the general partner (the partner that takes on the responsibility of the day-to-day operations and management of the fund and assumes total liability in return for negligible buy-in). Chapter 5 examines in detail the structure of limited partnerships and limited partnership contracts. The basic intermediation structure of venture capital and private equity funds is graphically summarized in Figure 1.1.

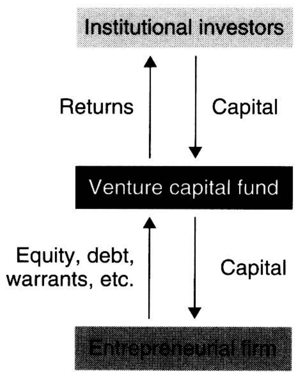

Figure 1.1 Venture Capital Financial Intermediation

Venture capital funds are typically set up with at least US$50 million in capital committed from institutional investors and often exceed US$100 million. Some of the larger private equity funds raised more than US$10 billion in 2006.[1] Fund managers typically receive compensation in the form of a management fee (often 1 to 2% of committed capital, depending on the fund size) and a performance fee or carried interest (20% of capital gains). Chapter 6 discusses factors related to fund manager compensation. Venture capital funds invest in start-up entrepreneurial firms that typically require at least US$1 million and up to US$20 million in capital. Private equity funds invest in more established firms, as discussed further below.

Venture capital is often referred to as the money of invention (see, e.g., Black and Gilson, 1998; Gompers and Lerner, 1999a,b,c, 2001a,b; Kortum and Lerner, 2000) and venture capital fund managers as those who provide value-added resources to entrepreneurial firms. Venture capital fund managers play

[1]See http://www.thomson.com/content/pr/tf/tf_priv_equiconsul/2006_07_17_2Q06_Mega_Funds_Drive.