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**THE MISSING PREFERRED RETURN**

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## ABSTRACT

Managers of buyout funds typically offer their investors an 8% preferred return on their investment before they take a share of any additional profits. Venture capitalists, on the other hand, rarely offer a preferred return. Instead, VCs take their cut from the first dollar of nominal profits. This disparity between venture funds and buyout funds is especially striking because the contracts that determine fund organization and compensation are otherwise very similar. The missing preferred return might suggest that agency costs pose a larger problem in venture capital than previously thought. Is the missing preferred return evidence, perhaps, that VCs are camouflaging rent extraction from investors?

This Article argues that the missing preferred return is evidence that venture capital compensation practices do not properly align incentives. Making VC pay subject to a preferred return would help investors screen out bad VCs and would motivate VCs more effectively when they find, court, and negotiate with entrepreneurs. This positive effect that the preferred return may have on “deal flow” incentives may be less important for VCs with strong reputations. Even for elite VCs, however, the status quo appears to be inefficient, albeit in a different way. If a fund declines in value in its early years, as is usually the case, the option-like feature of VC pay distorts incentives. Compensating VCs with a percentage of the fund, rather than just a percentage of the profits, would eliminate this distortion of incentives. Thus, the current industry practice is puzzling. None of the usual suspects like bargaining power, boardroom culture, camouflaging rent extraction or cognitive bias offers an entirely satisfactory explanation. Only by peering into a dark corner of the tax law can we fully understand the status quo.

The tax law encourages venture capital funds to adopt a compensation design that misaligns incentives but still maximizes after-tax income for all parties. Specifically, by not recognizing the receipt of a profits interest in a partnership as compensation, and by treating management fees as ordinary income but treating distributions from the carried interest as capital gain, the tax law encourages funds to maximize the amount of compensation paid in the form of a profits interest. One way to do this is to eliminate the preferred return, thereby increasing the present value of the carried interest, which in turn allows investors to pay lower tax-inefficient management fees.

# THE MISSING PREFERRED RETURN

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## I. Introduction

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Managers of buyout funds usually offer investors an 8% preferred return on their investment before they take a share of any additional profits. Venture capitalists, on the other hand, offer no preferred return. Instead, VCs take their cut from the first dollar of nominal profits. They offer investors no feature to account for investors' cost of capital, nor do they index their compensation to an industry benchmark. This disparity between venture capital funds and other private equity funds is especially striking because the contracts that determine fund organization and compensation are otherwise very similar. This Article examines the mystery of this missing preferred return.

The missing preferred return is troubling because it suggests that VCs may receive "pay without performance."<sup>1</sup> VCs receive incentive compensation even if their funds do poorly when compared to other venture funds, and even when compared to other, less risky investments that investors could have made. This gap between pay and performance suggests that agency costs in venture capital are a more stubborn problem than previously thought. In the public equities market, regulators strive to protect small investors. Many laws and regulations, such as the \$1,000,000 limit on the deductibility of executive pay that is not linked to performance,<sup>2</sup> are designed to protect investors who may not be able to effectively constrain management from extracting rents.<sup>3</sup> In private equity, however, the regulatory landscape reflects the conventional wisdom that sophisticated investors can look out for themselves.<sup>4</sup> The missing preferred return poses a challenge to this view. Are fund managers camouflaging the true value of their compensation? If not, then why would sophisticated investors pay fund managers for mediocre work? Unlike the children of Lake Wobegon, not every venture fund is above average.<sup>5</sup>

Take the University of California Retirement System, a prominent institutional investor. More than one in ten venture funds in which the UCRS invested has missed the common hurdle rate of 8% and nearly one in five would have received less compensation if the hurdle rate mechanism were used.<sup>6</sup> Using a preferred return would seem to make a difference. By leaving out a preferred return term, VC fund agreements reward mediocrity. This arrangement hardly seems efficient, let alone fair to retirees worried about their pension plan assets. Are VCs using compensation design to sneakily extract rents from their investors, as CEOs are said to do?

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<sup>1</sup> For a discussion of the problem of ineffective executive compensation design in the public company context, see LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004).

<sup>2</sup> See I.R.C. § 162(m).

<sup>3</sup> See Bebchuk & Fried, *supra* note 1; Michael C. Jensen & Kevin J. Murphy, *Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them*, ECGI Finance Working Paper 44/2004 (July 2004).

<sup>4</sup> See generally THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 4.20[2] (4<sup>th</sup> ed. 2002) (discussing definition of accredited investor).

<sup>5</sup> See Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-Ups*, 57 *TAX L. REV.* 142 n.20 (discussing Lake Wobegon effect); Bebchuk & Fried, *supra* note [xx], at 71-72 (discussing ratcheting effect and noting that the vast majority of firms that use peer groups to set compensation set it at or above the fiftieth percentile of the peer group).

<sup>6</sup> See UCRS data as of Sept. 30, 2004 (on file with author) (also available at <http://www.ucop.edu/treasurer/invret/PE%20irr%2093004.pdf>)

This agency costs story starts to feel a little thin, however, when one considers the presence of the preferred return in buyout funds. Investors routinely demand a preferred return in buyout funds. These very same investors then accept its absence in venture capital. With billions of dollars in fees at stake, the missing preferred return cannot be the product of greedy managers sneaking one past sleepy investors. No one is being hoodwinked here. Something else must be going on.

The secretive pay practices of the private equity world are worth investigating. Private equity fund managers, recently dubbed “Capitalism’s New Kings” by the Economist magazine, draw hefty management fees from investors, and they cash in on even greater amounts by taking a share of the profits of their funds.<sup>7</sup> This share of the profits is known as the “carry” or “carried interest.” In contrast to the considerable research on CEO pay,<sup>8</sup> private equity compensation practices are largely unexplored in the legal literature. Stock options are praised or scorned, but few know enough about the carried interest to even have an opinion. This Article uses the mystery of the missing preferred return to take the first hard look at the compensation of private equity fund managers.

I argue in this Article that the peculiar workings of the tax law, combined with institutional differences between venture capital and buyout funds, best explain the missing preferred return. Many VC funds leave out a preferred return because investors can rely on the reputation of elite VCs, along with contractual restraints, to ensure that VCs find and invest in high-quality portfolio companies. For VC funds that may be inclined to use a preferred return, the tax law changes the cost-benefit analysis and discourages the use of the preferred return. Institutional differences make the preferred return more valuable as a device for aligning incentives in buyout funds, and thus it is employed more widely in buyout funds, notwithstanding the tax cost. The preferred return would be used more widely in venture capital if the tax rules were changed. If I am right about the influence of tax, the implications are somewhat troubling. The gap between the economics of a partnership equity interest and its treatment for tax purposes distorts incentives by encouraging fund managers to receive more compensation in the form of risky equity rather than cash salary, which in turn may distort the operation of the venture capital markets. The main goal of this Article, however, is descriptive rather than normative. Before we can make informed policy judgments, we must first understand how these kings of capitalism are paid, and why.

The Article proceeds as follows. In Part II, I explain the basic mechanics of private equity compensation. I then frame the puzzle by looking at recent returns in venture capital and considering the importance of the preferred return. In Part III, I report the explanations offered by venture capitalists, investors, and lawyers who draft these agreements. In Part IV, I consider the effect the preferred return may have on the incentives of VCs. The efficiency of a given compensation scheme, I argue, may depend on the reputation of the VC. I conclude, however, that the missing preferred return cannot be explained by incentives and reputation alone. Part V argues that the final piece

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<sup>7</sup> See *Kings of Capitalism: A Survey of Private Equity*, THE ECONOMIST, Nov. 27, 2004 (special section).

<sup>8</sup> See Kevin J. Murphy, *Executive Compensation*, in HANDBOOK OF LABOR ECONOMICS (Orley Ashenfelter & David Card eds. 1999), at 1 (“... CEO pay research has grown even faster than CEO paychecks, skyrocketing from 1-2 papers per year prior to 1985 to sixty papers in 1995.”).

of the puzzle lurks in a dark corner of the tax law: an IRS administrative pronouncement concerning the taxation of a profits interest in a partnership. I argue that tax encourages venture capital funds to adopt a compensation design that misaligns incentives but still maximizes after-tax income for all parties. Part V also returns to the original question – the disparity between venture funds and buyout funds. I argue that the differences in the kinds of companies buyout funds invest make the preferred return necessary, notwithstanding the tax cost. Part VI concludes.

## II. The Puzzle

I begin with a prediction: the 21<sup>st</sup> century will be the golden age of private equity. The 20<sup>th</sup> century marked the rise of the modern public corporation and with it, the stubborn problem of the separation of ownership and control.<sup>9</sup> In the 1980s, the leveraged buyout model of firm organization led some scholars to predict the eclipse of the public corporation.<sup>10</sup> Public firms responded by improving efficiency; among other things, they now routinely link pay to performance.<sup>11</sup> But pay-for-performance can tempt executives to mislead public investors and artificially inflate short-term stock prices. More firms are again opting to go private.<sup>12</sup> Legal academics, meanwhile, myopically focus on the problem of agency costs in public companies. When academics do refer to private equity, most praise the powerful financial incentives provided to managers.<sup>13</sup> But surely there is more to it.

Private equity fund managers are playing with other people's money, just like CEOs. And, as with CEOs, there is some evidence that not all fund managers act like saints all of the time.<sup>14</sup> Understanding the carried interest may be the key to unlocking the problem of agency costs in private equity. Study of VC compensation began in earnest with Bill Sahlman's 1990 article in the *Journal of Financial Economics*, *The Structure and Governance of Venture-Capital Organizations*, where he identified the importance of the carried interest and noted that the option-like characteristic of the carry

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<sup>9</sup> See ADOLPH BERLE & GARDINER MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

<sup>10</sup> See Michael C. Jensen, *The Eclipse of the Public Corporation*, HARV. BUS. REV. (Sept.-Oct. 1989), p. 61. The cultural importance of the rise of the LBO model was captured most memorably in *BARBARIANS AT THE GATE* (HBO 1993); see also BRYAN BURROUGH & JOHN HELYAR, *BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO* (1990).

<sup>11</sup> The link between pay and performance may be largely cosmetic, however. See Bebchuk & Fried, *supra* note [xx], at 67-68 (discussing the concept of camouflage).

<sup>12</sup> See Ellen Engel, Rachel M. Hayes & Xue Wang, *The Sarbanes-Oxley Act and Firms' Going-Private Decisions* (available on ssrn.com) (May 6, 2004) (finding modest increase in going private decisions as a result of Sarbanes Oxley).

<sup>13</sup> See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1078 (2003).

<sup>14</sup> I am indebted to Vic Goldberg for this nifty phrase. On evidence of agency costs in venture capital, Marcus Cole and Joe Bankman have written that agency costs led VCs to make bad investments at the end of the Internet bubble, when they should have been allowing investors to hold on to their money. See Joseph Bankman & Marcus Cole, *The Venture Capital Investment Bust: Did Agency Costs Play a Role? Was it Something Lawyers Helped Structure?*, 77 CHL-KENT L. REV. 211 (2001). Paul Gompers and Josh Lerner identify the problem of "grandstanding," where VCs take portfolio companies public prematurely to improve future fundraising efforts. See Paul A. Gompers & Josh Lerner, *THE VENTURE CAPITAL CYCLE* (1999), chap. 12.

could distort incentives.<sup>15</sup> Financial economists Paul Gompers and Josh Lerner, in their highly influential book, *The Venture Capital Cycle*, argued that establishing reputation was an important motivation for new VCs, and that the compensation of established funds was more sensitive to performance than that of other funds.<sup>16</sup> In recent years economists have written literally hundreds of articles about venture capital, though few articles examine agency costs at the fund level.<sup>17</sup>

The legal academy has a long way to go in order even to catch up with financial economists. Ron Gilson was the first legal academic to pay close attention to the agency costs problem in venture capital. Gilson noted that the GP's compensation structure is the "front line response to the potential for agency costs" resulting from giving the GP control over the fund's investments.<sup>18</sup> But Gilson's discussion of the carried interest stopped short of a detailed examination of carried interest design.<sup>19</sup> More recently, Kate Litvak has undertaken an ambitious empirical study of venture capital fund agreements.<sup>20</sup> Among other things, Litvak argues that the practice of staging capital calls creates an option to abandon that helps mitigate agency costs.<sup>21</sup> Other developments in private equity fund contracting that may address agency costs, such as "no-fault divorce" clauses that allow limited partners to fire the general partner, have yet to receive much attention by the academy.<sup>22</sup> In sum, the legal academy is just coming to the realization, which our finance colleagues realized a decade ago or more, that studying private equity can provide a useful way to examine the old problem of the separation of ownership and control. Private equity gives us a window, relatively free from the distortions of securities regulation, to see what sort of private ordering the market can develop on its own to address agency costs. And while I conclude in this Article that private ordering fails to properly align incentives, the distortion here is not caused by collective action problems, boardroom culture, camouflaged compensation, or accounting rules. Instead,

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<sup>15</sup> See William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. Fin. Econ. 473, 494-499 (1990).

<sup>16</sup> See Gompers & Lerner, *supra* note [xx], at 81. Litvak's research undermines some of Gompers & Lerner's key findings. See Litvak, *Understanding Compensation Arrangements*, *supra* note xx, at pin.

<sup>17</sup> An SSRN search for the term "venture capital" in the title or abstract generated 500 hits; a search for "venture capital" in the title only generated 199 hits. See [ssrn.com](http://ssrn.com) (site last visited Feb. 21, 2005).

<sup>18</sup> See Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons From The American Experience*, 55 STAN. L. REV. 1067, 1089 (2003). See also David Rosenberg, *The Two "Cycles" of Venture Capital*, 28 J. CORP. L. 419 (2003); David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363.; Joseph W. Bartlett & W. Eric Swan, *Private Equity Funds: What Counts and What Doesn't?*, 26 J. CORP. L. 393 (2001) (noting importance of design of carried interest).

<sup>19</sup> Regarding the design of the carried interest, Gilson noted only that certain adjustments could be made after the fact to prevent certain abuses by the GP. These adjustments are known as a "clawbacks." See Gilson, *supra* note [xx], at [1089]; JAMES M. SCHELL, *PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS* sec 2.04[2] (2000).

<sup>20</sup> See Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements* (available on [ssrn](http://ssrn.com)).

<sup>21</sup> See Kate Litvak, *The Price of Stability: Default Penalties in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. [pin] (2004). But see Victor Fleischer, *Fickle Investors, Reputation, and the Clientele Effect in Venture Capital Funds*, 40 WILLAMETTE L. REV. [pin] (2004) (questioning whether default penalties are an effective governance device).

<sup>22</sup> See David Toll, *PRIVATE EQUITY PARTNERSHIP TERMS AND CONDITIONS* 62 (2d ed. 2001); WILLIAM M. MERCER INC., *KEY TERMS AND CONDITIONS FOR PRIVATE EQUITY INVESTING* 42 (1996) (hereinafter "The Mercer Report").

the villain is the tax law. The peculiar tax treatment of a profits interest in a partnership encourages parties to keep the status quo, even though some alternative designs might better align incentives.

### A. Venture Capital Funds vs. Buyout Funds

Like the dog that didn't bark, the missing preferred return is remarkable only in context.<sup>23</sup> Private equity funds share basic structural qualities even though the underlying companies they invest in vary widely. The private equity market is made up of distinct investment partnerships, called funds. Each fund uses a pre-defined investment strategy that focuses on a particular asset class: investors may choose from buyout funds, merchant banking funds, real estate funds, venture capital funds, Asian funds, mezzanine funds, and so forth.<sup>24</sup> Within each asset class, funds may target particular industries within a sector, such as Internet companies, software, biotechnology, or health care start-ups.<sup>25</sup> This Article focuses on a difference in compensation structure in two particular types of private equity funds, defined by asset class: venture capital funds and buyout funds. Although I focus on the preferred return in buyout funds, what is true for buyout funds is also generally true for real estate funds, mezzanine funds, funds of funds, and other private equity investments. When it comes to the preferred return, only venture is different.

Basic fund organization is the same for venture funds and buyout funds. Funds are organized as limited partnerships or limited liability companies under state law. Investors become limited partners (LPs) in the partnerships and commit capital to the fund. A general partner (GP) manages the partnership in exchange for an annual management fee, usually between 1.5 and 3 percent of the fund's committed capital. The GP also receives a share of any profits; this profit-sharing right is called the "carry" or "carried interest." The carried interest aims to align the incentives of the GP with those of the LPs. Because the GP can earn significant compensation if the fund performs well, the fund managers are driven to work harder and earn profits for the partnership as a whole. The GP also contributes about 1% of the capital to the fund. This amount, which is largely an artifact of tax history, is small in comparison to the carry and generally has a negligible effect on incentives.<sup>26</sup>

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<sup>23</sup> See ARTHUR CONAN DOYLE, *SILVER BLAZE*.

"Is there any other point to which you wish to draw my attention?"

"To the curious incident of the dog in the night-time."

"The dog did nothing in the night-time."

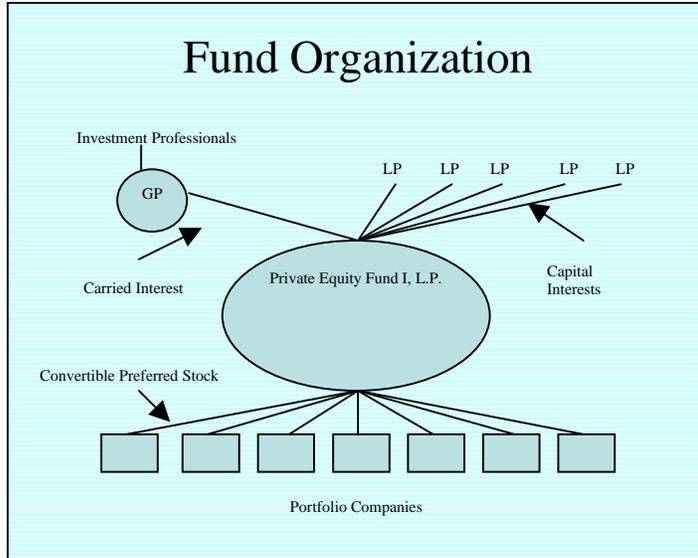
"That was the curious incident," remarked Holmes.

<sup>24</sup> The type of fund, in other words, refers to the type of investment rather than who the investors are.

<sup>25</sup> For example, in 2002 venture investments were divided into the following sectors: Communications (including Internet) 24%, Computer Software 20%, Biotechnology 13%, Healthcare Related 11%, Computer Hardware and Services, 9%, Semiconductors and Electronics, 7%, Retailing and Media, 7%, Business/Financial, 4%, and Industrial/Energy, 4%. See 2003 NATIONAL VENTURE CAPITAL ASSOCIATION YEARBOOK (Thomson Venture Economics), at 28.

<sup>26</sup> Before the check-the-box rules, a 1% capital interest was necessary to help ensure partnership classification for tax purposes. See Schell, *supra* note [xx], at § 3.02[2]; Victor E. Fleischer, *If It Looks Like a Duck: Corporate Resemblance and Check-The-Box Tax Classification*, 96 COLUM. L. REV. 518 (1996). Some LPs are pushing for increase to 2 or 3%, which may reflect some of the concerns discussed *infra* in the section on deal harvesting incentives.

After formation, the GP deploys the capital in the fund by investing in different operating businesses, known as portfolio companies. After making the initial investment, the GP becomes a formal or informal advisor to the companies. In most venture funds, the portfolio companies are high-tech start-ups, and the GP's ultimate goal is to take the portfolio companies public or sell the companies' stock or assets to another company. In buyout funds, the fund makes sizeable investments



in mature companies. The fund then might reorganize the company, change its corporate strategy, or make aggressive changes in management to improve its operations. Buyout funds then eventually sell each portfolio company to a trade buyer, break it up and sell off the assets, or take the portfolio company public again, selling shares back to public shareholders at a profit. Lately, with IPO markets cold, buyout funds have increasingly looked to sell to other buyout funds as an exit strategy.

Both venture capital funds and buyout funds use the carried interest to create powerful economic incentives for the GP. The GP is itself a partnership or LLC with a small number of professionals as members. The GP receives a management fee that covers administrative overhead and pays the managers' salaries. The management fee is fixed and does not depend on the performance of the fund. The carry, on the other hand, is performance-based. Because private equity funds are leanly staffed, a carried interest worth millions of dollars may be split among just a handful of managers. For successful fund managers, private equity is a lucrative game.

## 1. The carry in leveraged buyout funds

In buyout funds, the carried interest is subject to a preferred return requirement that works as follows. Before the GP receives any carry, the LPs first receive a preferred return on their investment, often 8%. The preferred return ensures that LPs receive at least as much as they would have made on safer market investments before the GP takes a share of the profits. The mechanics of allocation and distribution of profit and loss in partnership agreements are famously intricate and difficult to follow. While the general structure of fund agreements is largely standardized, details in drafting vary, and certain terms, like those pertaining to the timing of distributions, are often heavily negotiated.<sup>27</sup> Without spelunking too deep into partnership agreement drafting issues, it is worth highlighting the basic mechanics of partnership allocation and distribution as they pertain to the preferred return.

<sup>27</sup> See Bartlett & Swan, *supra* note [xx].

Capital accounts track the economic arrangements of partnerships. Allocation provisions increase and decrease capital accounts of individual partners as the partnership realizes gains or losses. Thus, when a fund sells an investment at a profit, each partner receives an allocation of profit and its capital account is increased according to the terms of the agreement. Distribution provisions then determine the order each partner receives actual distributions of cash or securities. When there is a gap between allocation and distributions, the difference is made up when the fund is liquidated.<sup>28</sup> Capital accounts thus define the true economic arrangement amongst the partners; timing and credit risk issues aside, a partner's take will ultimately match its capital account. The partnership agreement may be drafted so that the key economic terms are stated in either the allocation or distribution provisions; for simplicity here I assume that the allocation provisions do the heavy lifting, and that the distributions then follow the allocations.

An allocation provision with a preferred return could say that as gains are realized from partnership investments, allocations will occur as follows:

- First, 100% to the LPs until such time as the LPs have received back their initial contribution of capital,
- second, 100% to the LPs until they have received an amount equal to 8% return, compounded annually, on their initial investment, and
- thereafter, 80% to the LPs and 20% to the GPs.<sup>29</sup>

Such an arrangement is called a “true” preferred return. It is also sometimes called a “floor,” because the GP receives no carry until reaching the 8% return.

The phrase “hurdle rate,” often used interchangeably with “preferred return” in the industry, more accurately describes the actual mechanics of most agreements.<sup>30</sup> A hurdle rate means that once the GP has returned the initial capital plus an 8% return, it has cleared the hurdle and becomes entitled to take the full 20% carry. To achieve this goal, the agreement includes a “catch-up” provision. A partnership agreement with a hurdle rate thus might say that allocations take place as follows:

- first, 100% to the LPs until the LP has received 100% of its initial capital back,

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<sup>28</sup> Sometimes, there is not enough cash remaining in the partnership to square off the accounts at liquidation. In that case, a clawback provision will be used to ensure that the economics of the partnership ultimately match up with the capital accounts. See *infra* text accompanying notes [xx].

<sup>29</sup> A brief numerical example may help. Suppose the LPs contribute \$100 to the partnership, which buys stock in a single company, Acme Inc., for \$100. One year later the partnership sells its Acme stock for \$158. The first \$100 is allocated to the LPs, returning their initial investment in the partnership. The LPs are then allocated \$8, representing the preferred return. \$50 remains and is split 80-20, with the LPs receiving an allocation of \$40 and the GPs receiving an allocation of \$10. The LPs will have capital accounts totaling \$148 (\$100 + \$8 + \$40) and the GP will have a capital account of \$10. Note that because of the preferred return, the GP's final share of the profits is less than 20% ( $\$10 / \$58 = 17.2\%$ ).

<sup>30</sup> See Jack S. Levin, *STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS* (2004) at § 10-10 (noting that “permanent preferential return” is used less commonly).

- second, 100% to the LPs until the LPs have received an amount equal to 8% return, compounded annually, on their initial investment,
- third, 100% to the GP until the GP has “caught up” and received 20% of the amount in excess of the initial investment, and
- thereafter, 80% to the LPs and 20% to the GPs.<sup>31</sup>

In contrast to a true preferred return, the significance of the hurdle rate vanishes after it is cleared. After the catch-up amount, the GP receives 20% of the total nominal profits of the fund, erasing any measure of the LP’s cost of capital.

The compounding of the preferred return rate is what makes it an important contract term. Private equity funds have a life, defined by contract, of 10 to 12 years. If an LP invests \$100 in a ten-year fund, an 8% preferred return (compounded annually) means that LP must receive \$216 before the GP may take any carry.

Complicating matters even further is the fact that, in many partnership agreements, the hurdle must only be cleared once. A fund may invest in as many as ten or fifteen portfolio companies, each of which is later sold at a different time. Many fund agreements are structured so that if the GP realizes an investment (i.e. sells a portfolio company) or series of investments at a cumulative profit that clears the then-applicable hurdle rate, the catch-up provision kicks in and the GP is thereafter entitled to its 20% carry, even if—in the long run—the fund’s overall return falls below 8%. Thus, if a fund has one or two early successes at a large profit, and then equal successes and failures thereafter, for an overall return of 5%, the GP would receive 1% (20% of the 5%) as carry.

Finally, some funds allow GPs to receive carry on a deal-by-deal basis, making a “clawback” provision necessary. A “clawback” provision determines what happens when the GP has some early successes, which entitles it to receive carry, but then sees later investments fail to show profits. If the overall return of the fund drops below zero, then the GP will incur an obligation to return the amount received as carry to the fund. The clawback ensures that the carry is ultimately determined on an aggregate level, rather than portfolio company-by-portfolio company.<sup>32</sup>

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<sup>31</sup> Suppose the LPs contribute \$100 to the partnership, which then buys stock in a single company, Acme Inc., for \$100. One year later the partnership sells its Acme stock for \$158. The first \$100 is allocated to the LPs, returning their initial investment in the partnership. The LPs are then allocated \$8, representing the preferred return. The GP is then allocated \$2, representing the catch-up. \$48 remains, and is split 80-20, with the LPs receiving an allocation of \$40.40 and the GP receiving an allocation of \$9.60. The LPs will have a capital account of \$146.40 and the GP will have a capital account of \$11.60. Note that because of the catch up provision, the GP’s final share of the profits, \$11.60 / \$58, is exactly 20%.

<sup>32</sup> Suppose the LPs invest \$100 in a fund, which invests \$50 in Beta Inc. and \$50 in portfolio company, Gamma Inc. One year later, the Beta stock is sold for \$85. Under the terms of the partnership agreement, the first \$50 is allocated to the LPs, the next \$4 (8% \* 50) is allocated to the LPs, the next \$1 is allocated to the GP (the catch up amount) and the remaining \$30 is split \$24-\$6 between the LPs and the GP. The GP has thus received \$7 in carry from the \$35 in profits from the sale of Beta stock. The LPs have received a total of \$78. Nine years later, Gamma Inc. files for bankruptcy, and the fund’s Gamma stock is deemed

The mechanics of allocation, distribution, and clawback are as important as they are difficult to draft. These provisions determine how funds divide up profits; as such, they influence the behavior of the managers.

## 2. The carry in venture capital funds: the missing preferred return

Venture capital funds, in contrast to other buyout funds, do not give LPs a preferred return or hurdle rate. All profits are divided 80-20 between the LPs and the GP. While obviously simpler than using a preferred return mechanism, this allocation seems to fail the basic goal of contingent compensation arrangements: rewarding superior performance. By failing to use a preferred return, venture funds reward both superior and mediocre performance.

A simple example illustrates the problem. Suppose the LPs invest \$100 million in a typical fund with a ten-year life. The fund shows returns of 4% per year, and at the end of ten years the portfolio companies are sold for a total of \$148 million. Despite this sub-par performance, the GP will receive nearly \$10 million of carry. And yet the LPs could have achieved a better return on their investment by investing in safer securities, such as corporate bonds or even ultra-safe Treasury bonds. Given the sophistication of the institutional investors who make these investments, the compensation design is puzzling.

The absence of a preferred return in venture funds is common but not universal. In a recent detailed empirical study of venture capital partnership agreements, none of the 38 agreements studied contained a preferred return.<sup>33</sup> Most practitioners I spoke with reported not using a preferred return. On the other hand, one recent industry study reported that “[p]referred returns have become dramatically more popular among venture funds in the past two years.”<sup>34</sup> That study reported that 35% of venture capital fund agreements included a preferred return.<sup>35</sup> It is useful to know that some venture funds do include a preferred return; one possibility, discussed below, is that the VC’s reputation helps account for the disparity in contract design.<sup>36</sup> Similarly, the presence of the preferred return in buyout funds is common but not universal. In one recent survey, 90% of buyout funds used a preferred return.<sup>37</sup>

### B. How It Matters

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worthless. The fund prepares for liquidation. Under the terms of the partnership agreement, the GP must return the \$7 of carry to the partnership, since the LPs have not received back their initial \$100 investment in the fund.

<sup>33</sup> See Litvak, *supra* note [xx]. In an email exchange, Professor Litvak confirmed that none of the agreements contained preferred return provisions.

<sup>34</sup> See David Toll, *PRIVATE EQUITY PARTNERSHIP TERMS AND CONDITIONS* (2d ed. 2001), at 53.

<sup>35</sup> *See id.*

<sup>36</sup> *See infra* text accompanying notes [xx]; Daniel Covitz & Nellie Liang, *Recent Developments in the Private Equity Market and the Role of Preferred Returns* (available on [ssrn.com](http://ssrn.com)) (Jan. 2002 draft) at 17.

<sup>37</sup> See Toll, *supra* note [xx], at 52.

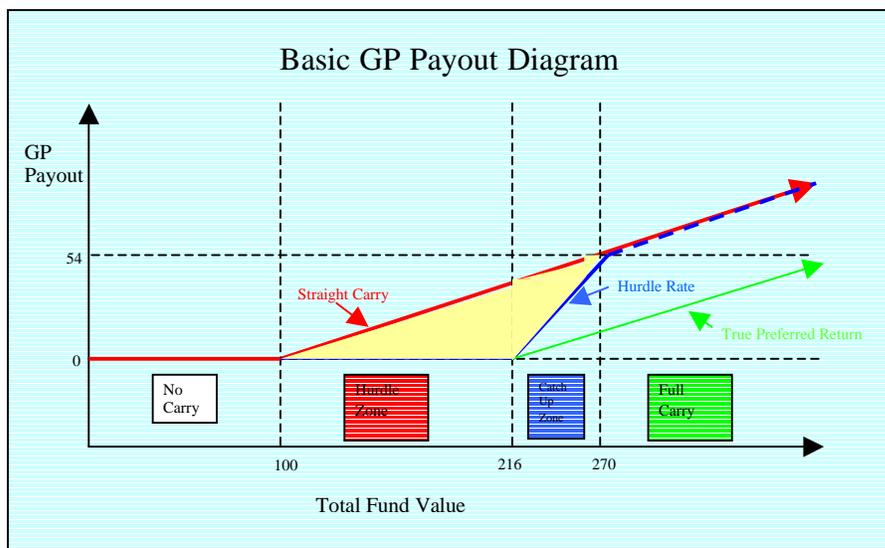
Venture investing is risky business. At first glance, considering the presence or absence of a preferred return seems like a trivial pursuit. After all, if a venture fund invests in a series of Internet flame-outs, the GP would not receive any carry at all. If it funds the next Google, returning the LPs' initial investment ten-fold, then the GP would clear any hurdle, making the preferred return irrelevant.<sup>38</sup>

In fact, the absence of a preferred return can and does make a difference in the real world. The compounding effect of the preferred return calculation makes it significant over the course of a ten or twelve year fund. Moreover, the risky nature of venture investing is sometimes overstated. It is certainly true that many of the underlying investments in start-ups will turn out to be worthless. The gamble at the portfolio company level is moderated, however, by the aggregation of risk at the fund level. A venture fund might make investments in ten or fifteen portfolio companies. While each individual portfolio company is very risky, funds are somewhat less so.

And so it is worth a closer look at when the preferred return really matters. The preferred return matters when one of two situations arises: funds that make some profits but never clear the hurdle rate, and profitable funds that clear the hurdle but then fall back.

### 1. Nominally profitable funds

The first and more obvious way that the preferred return makes a difference is when a fund is profitable but never clears the hurdle rate. Suppose LPs invest \$100 in a fund and ten years later receive back \$150. In the absence of a preferred return, even though the investment has a negative net present value (in hindsight), the GP is able to take \$10 of the \$50 “profit” as the carried interest. If the partnership agreement included a preferred return, the GP receives no carry.



<sup>38</sup> See Gary Rivlin, Google is One for the Books, Leaving Some With Regrets, New York Times, Aug. 23, 2004, at C1 (discussing how Google’s VCs turned \$11 million into \$3 billion in five years).

The preceding diagram shows the payout scheme for (1) “**straight carry**”: a fund with no preferred return (most VC funds), (2) “**hurdle rate**”: a fund with a preferred return and a 100% catch-up provision (most buyout funds) and (3) a **true preferred return**. The red line represents the payout for most VC funds and shows positive returns starting at 100 and increasing with a slope of 0.2. The green line shows the payout for a true preferred return, starting at 216 and increasing with a slope of 0.2. The blue line, which represents the payout for most buyout funds, starts at 216 (the hurdle number) but starts with a slope of 1. This is the catch-up period, where every additional dollar earned by the fund is allocated to the GP. Once the catch-up point is reached, additional allocations are 80-20, bringing the payouts back in line with funds with no preferred return.

The triangle shaded in yellow represents the possible difference in value between a fund with and without a hurdle rate. If the fund value falls between 100 and 270, the value of the preferred return to the LP can be determined by the height of the triangle at that point. The expected value of the preferred return is more difficult to calculate, of course, because it depends on the probability that the fund value will end up in that range and the effect that the preferred return has on that probability.

## 2. Clawbacks in profitable funds

The second, more subtle way that the preferred return makes a difference is in the calculation of clawbacks. Suppose a fund has some early successes but later failures. At a minimum, the GP, which received carry on the early successes, has to give back any carry in excess of 20% of cumulative profits.

Some partnership agreements go further, however, requiring the GP to give back any carry in excess of the initial capital investment plus a preferred return.<sup>39</sup> Suppose a fund with an initial value of \$100 has some early success, reaping \$110 from the sale of portfolio companies and a total profit of \$30. The GP receives \$6 of carry. The remaining portfolio companies fail, and the fund liquidates after three years. The preferred return now amounts to \$126.<sup>40</sup> At the time of liquidation, the GP would have to give back not just the \$4 in excess profits, but the full \$6, because the fund has returned just \$110; it has not, in the aggregate, cleared the \$126 hurdle. Such a clawback provision, which I call a “creeping clawback,” reflects the economics of a true preferred return by guaranteeing a minimum return to the LPs in any profitable situation. Without a creeping clawback, a preferred return accomplishes this goal if the fund has failures before successes but not vice versa.<sup>41</sup>

<sup>39</sup> See Schell, supra note [xx], at 2-24.

<sup>40</sup> The calculation is as follows:  $\$100(1.08)^3 = \$126$ .

<sup>41</sup> A creeping clawback reduces an important timing benefit GPs enjoy when they achieve early successes in a fund but later failures. Under a traditional clawback, the GP must return excess carry to the fund – but without interest. Kate Litvak has noted how this is equivalent to an interest free loan from the LPs to the GPs. See Litvak, supra note [xx]. In the example above, under a traditional clawback, the GP keeps \$2 and returns \$4 to the LPs for a net of 20% (\$2 out of \$10 total profits). In addition, however, the GP has enjoyed the use of the \$4 in the interim, interest-free. Litvak’s research suggests that this timing benefit is quite valuable. Under a creeping clawback, the GP returns the full \$6 of nominal carry to the LPs. While the GP still enjoys the use of the \$6, the overall return to the GP is obviously much lower than a traditional clawback. Under a traditional clawback, the GP keeps \$2 plus the interest on \$6; under the creeping clawback, the GP keeps just the interest on \$6. One might be troubled by the GP receiving anything in this

### C. How Often It Matters: Empirical Evidence

What impact would including a preferred return have on real world venture capital funds? Empirical data suggests the term is more important than conventional wisdom suggests. For the University of California Retirement System, a prominent institutional investor, nine out of forty-six venture funds from vintage years 1979 through 1998 showed returns below 10%. Of these, four were between 8 and 10%, which would place the fund in the “catch-up” zone. Three others were positive but below 8%.<sup>42</sup> Thus, for the University of California, in seven out of forty-six funds the presence of the preferred return term would have affected the payment of the carried interest to the GP.

This apparent pay-for-underperformance is likely to get worse in the next few years. Many venture funds in vintage year 1999, 2000 and 2001 invested heavily in Internet companies.<sup>43</sup> GPs took carry on early successes as Internet companies went public. Remaining portfolio companies have a slim chance of matching those earlier successes; many expect the returns for funds from vintage years 1999-2003 to have sub-par returns.<sup>44</sup>

A possible explanation for the lack of academic attention paid to the missing preferred return is the difficulty of obtaining data. Venture capital funds are exempt from the reporting requirements of the Securities Acts of 1933 and 1934 and the Investment Company Act of 1940.<sup>45</sup> Investors instead bargain for a contractual rights to observe how their capital is being deployed and calculate returns based on actual cash received back from the partnership. Because this information is confidential, it is difficult to find reliable data showing returns for large numbers of funds over time to get a full sense of the importance of the preferred return.<sup>46</sup> Practitioners report that arguments about the preferred return often devolve into simplistic arguments about what the “industry standard” is.<sup>47</sup>

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situation; one could imagine forcing the GP to pay back interest as well, even if that meant forcing the GP to dip into its own pocketbook beyond previously received carry. Traditionally, funds have avoided asking GPs to ever pay money into the fund beyond a 1% capital commitment at the time of initial investment.

<sup>42</sup> See UCRS data, *supra* note [xx]. The relevant returns were: 5.5%, 7.0%, 8.4%, 9.2%, 8.4%, 4.5%, 9.3%, -10.7%, -4.3%. Variation in the calculation of the preferred return makes it difficult to know for sure how many funds would be affected. Still, this frequency is enough to show that the contract term is not trivial.

<sup>43</sup> See Bankman & Cole, *supra* note [xx].

<sup>44</sup> To make matters worse, as noted above, VCs who have taken carry on early successes have a strong incentive to delay liquidation of the fund, as the benefit of holding on to carry without incurring interest has significant financial impact. See Litvak, *supra* note [x]. at pin. A creeping clawback would counteract this incentive to delay by increasing the amount the GP has to pay back to the fund by 8% per year. See *supra* text accompanying notes [xx].

<sup>45</sup> See Schell, *supra* note [xx], at § 8.01[1].

<sup>46</sup> More data has become available recently as journalists and investor watchdogs have used state public records statutes to request information about the investment returns of state pension funds. GPs are not pleased about this trend, nor are LPs who are being asked to leave some of the most prestigious funds. See Ann Grimes, *Their Secretive Ways at Stake, Venture Firms Cut Off Investors*, Wall St. J., Tuesday May 11, 2004, at A1.

<sup>47</sup> See Joseph W. Bartlett & W. Eric Swan, *Private Equity Funds: What Counts and What Doesn't?*, 26 J. CORP. L. 393, 394 (2001).

The fact that the preferred return only comes into play in a subset of cases does little to explain the puzzle. Given that buyout funds and other private equity funds routinely include hurdle rates, all else equal one would expect venture funds to follow suit. More importantly, perhaps, clearing the hurdle rate does not mean that the contract term was irrelevant. The significance of the preferred return term is more than distributional; it changes incentives. In the absence of a preferred return term, a GP may do a mediocre job, performing below the industry average, and still receive a nominally performance-based reward. Incentives are misaligned. The problem is fairly obvious, easy to fix, occurs in the real world, and yet remains unaddressed by the lawyers, venture capitalists, and institutional investors who negotiate these contracts. The puzzle remains, then: why do venture funds fail to include a preferred return?

### III. Conventional Wisdom

The conventional wisdom about the missing preferred return is grounded in the “home run” mentality of venture investing.<sup>48</sup> Most private equity funds – real estate funds, buyout funds, mezzanine funds, etc. – invest in established companies with positive cash flows. Venture funds, on the other hand, invest in start-ups with no immediate possibility of positive cash flow and only an uncertain hope of making money in the future. Venture funds like to bet on “disruptive technologies” – companies with products that can change entire product markets.<sup>49</sup> Most of these risky bets fail. The high-risk, high-reward strategy makes it silly, say some fund managers, to quibble about preferred returns. Either the gamble pays off and everyone goes home happy, or they shake it off and look to the next fund.

The problem with this home-run-mentality explanation is that investors seem unlikely to fall for it. The underlying assumption – that venture funds are either enormously successful or complete failures – simply isn’t true. It is true that portfolio companies are mostly successful or not; only a few become “zombies” with middling returns.<sup>50</sup> But funds, because they aggregate investments in as many as fifteen or twenty portfolio companies, have less variable returns. And when funds do moderately well, hurdle rates come into play. Moreover, if the presence or absence of a preferred return were insignificant, then one might just as well expect to find the term included rather than excluded, given its nearly universal presence in other types of private equity funds.

#### A. Bargaining Power

Many venture capitalists offered bargaining power as an explanation for the absence of a preferred return. The demand for venture capital funds soared in the late 1990s, putting VCs in a favorable bargaining position. But bargaining power, by itself,

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<sup>48</sup> See Fleischer, *Rational Exuberance*, supra note [x], at pin; Bankman, *Structure of Silicon Valley Start-Ups*, supra note [x], at pin.

<sup>49</sup> Interview with Geoffrey Smith.

<sup>50</sup> Even this truism – that portfolio companies are either home runs or strikeouts – is an exaggeration. Compare Marcus Cole, *Preference for Preferences* (draft on file with author) (arguing that middle ground is more important) with Ronald J. Gilson & David M. Schizer, *A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874 (2003) (arguing that middle ground is relatively small and cannot explain use of preferred stock).

cannot explain the puzzle. Bargaining power is better at explaining the *amount* of compensation one receives rather than the *form* of the compensation.<sup>51</sup> Nor does bargaining power explain why VCs would choose to exercise their power here, on such an arcane contract term, rather than elsewhere in the contract. After all, the preferred return term only matters in certain circumstances. An optimistic VC might bargain for a higher percentage of the profits; a pessimist might bargain for a higher management fee. Only a deeply ambivalent VC would bargain for the absence of a preferred return term.

Moreover, bargaining power has limited explanatory power because VCs have not always been in the dominant position at the negotiation table. As recently as the mid-1990s, many venture funds offered attractive deal terms to lure investors. At the peak of this pro-LP period, a group of prominent institutional investors retained a consulting firm, Mercer Investment Consulting, to recommend changes to the design of fund agreements that LPs should press for.<sup>52</sup> The Mercer Report proved to be controversial within the venture industry. The report recommended some aggressive, pro-LP changes like no-fault divorce clauses, advisory committees, and suspension-of-capital-call provisions.<sup>53</sup> Some changes have been widely adopted; others have not.<sup>54</sup> What is remarkable is that in the midst of this wish list, the Mercer Report offered only lukewarm support for a preferred return in the venture context.<sup>55</sup> If bargaining power were the true explanation, one would have expected the Mercer Report to unambiguously suggest that LPs press for the term.

## **B. Historical Explanations and Contract Stickiness**

History provides a clue, namely that the institutional differences between venture funds and buyout funds may help solve the puzzle. When venture funds were first formed in the 1950s and 1960s, returns were calculated on an investment-by-investment basis (i.e., portfolio company-by-portfolio company). Given the volatility of portfolio company returns, returns rarely fell in the middle range where the preferred return would come into play. The costs of negotiating the term, drafting it, and explaining its relevance to clients may have even exceeded any increase in efficiency.<sup>56</sup>

Practitioners devised the preferred return when real estate funds and leverage buyout funds grew in popularity in the 1970s. The expected returns from real estate and buyout investments were smaller and less volatile than venture investments. Also, these funds began to calculate the carried interest on the aggregate level, further reducing the volatility of returns. With middling returns more common, investors settled on a hurdle rate as a way of calculating a true performance-based return. Little has changed since the

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<sup>51</sup> See, e.g., Stewart J. Schwab & Randall Thomas, *What Do CEOs Bargain For? An Empirical Study of Key Legal Components of CEO Employment Contracts*, (working paper available on SSRN.com).

<sup>52</sup> See William M. Mercer, Inc., *Key Terms and Conditions for Private Equity Investing*, 1996 (copy on file with author).

<sup>53</sup> See *id.* at 1-4.

<sup>54</sup> See Toll, *supra* note [xx], for a discussion of current practices.

<sup>55</sup> See Mercer Report, *supra* note [xx], at 25. The Mercer Report's reasoning is discussed below. See *infra* at text accompanying notes [xx].

<sup>56</sup> There are both distributional and efficiency implications for the preferred return; it only makes sense to add a new term to a contract if the efficiency gains outweigh the drafting costs. If the drafting costs exceed efficiency gains (i.e. creating a net efficiency loss), then both parties are better off leaving the term out.

1970s: buyout, real estate, and other funds generally have a preferred return, while venture generally does not.

Nowadays venture funds also calculate profits on an aggregate basis, not deal-by-deal. History helps explain the initial divergence but does little to justify the status quo. The stickiness of contract terms is another possible barrier between the status quo and a more efficient contract.<sup>57</sup> Absent a pressing need to change, lawyers tend to copy language from prior agreements and may not fully consider other options.<sup>58</sup> In this case, however, contract stickiness is an unlikely explanation. The cost of switching to a preferred return is very low. The increase in drafting costs is minimal: the same law firms, and often the very same lawyers, draft fund agreements for both buyout funds and venture funds, and thus could easily drop in language that works. Moreover, these same lawyers are already familiar with the mechanics of preferred returns, making the cost of educating clients relatively low. Furthermore, the language at issue is not boilerplate. Terms are scrutinized and negotiated, especially in recent years.<sup>59</sup>

Thus, while history can help explain how the disparity between venture and buyout developed, it does little to explain its persistence. With large amounts of money at stake and switching costs relatively low, one would expect the lawyers and investors who negotiate these contracts to gravitate towards more efficient contract terms.

### C. Lack of Cash Flow

The Mercer Report suggested that a preferred return would be inappropriate for venture funds because the underlying portfolio companies in venture funds – start-ups – do not have any cash flow available to pay the preferred return.<sup>60</sup> Buyout funds, on the other hand, invest in established companies that generate cash. The intuition seems to be that a preferred return only makes sense when a steady stream of cash flow exists.

The intuition is understandable. Paying a preferred return on a risky investment is counterintuitive to corporate finance gurus. In most contexts, when an investor is entitled to a preferred return, the return is actually paid, and not just accrued, on a quarterly or semi-annual basis from cash flow generated by the business. A holder of preferred stock in a corporation expects to receive regular dividends.<sup>61</sup> Investors, therefore, generally associate preferential payouts with the availability of cash flow.

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<sup>57</sup> See Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds* (working paper available on SSRN); Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. Rev. 931 (1993); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 Va. L. Rev. 713 (1997).

<sup>58</sup> See Claire A. Hill, *Why Contracts are Written in “Legalese”*, 77 CHI-KENT L. REV. [pin] (2001)

<sup>59</sup> See Jerry Borrell, Work in Progress Column, VENTURE CAP. J., Jan. 1, 2004, at 1.

<sup>60</sup> See Mercer Report, *supra* note [xx], at 25. Given the disparity between venture funds and the rest of private equity, one would have expected the Mercer Report to recommend including a preferred return. In fact, the Mercer Report says little about the absence of the preferred return in venture funds; it notes only that “[i]t is found less frequently in early stage venture capital funds because these investments generally do not produce cash early in the life of the partnership.” *Id.*

<sup>61</sup> An even better example is debt: it would make no sense to finance a venture fund entirely with debt, as the lack of steady cash flow would place the fund in default, triggering a costly bankruptcy.

Like bargaining power and history, however, cash flow fails to hold up as a robust explanation. Because LPs lack the power to place the fund in default if the preferred return is not paid, interim cash flow is not relevant; only the ultimate performance of the fund matters. The goal of the preference is to benchmark the performance of the manager by affecting the capital account, not to establish priority of distribution of available interim cash flow. Preferences perform this role in other areas of corporate finance and even in the venture context. For example, in the case of convertible preferred stock investments in start-ups, the dividend preference may accrue, giving the fund a larger stake in the company over time, and also giving the preferred stockholders priority in the event of liquidation.<sup>62</sup>

#### **D. Horizontal Equity with Public Company Executives**

Efficiency may not be the only driver of compensation practices. Horizontal equity – in the sense of making as much money as one’s peers – might also help explain the makeup of a compensation package.<sup>63</sup> The leading treatise on private equity funds, James Schell’s *Private Equity Funds: Business Structure and Operations*, justifies the missing preferred return by pointing to public company executives.<sup>64</sup> Public company executives, Schell explains, do not have similar requirements.<sup>65</sup> Schell recognizes that the preferred return can affect the performance of management, noting that “a Preferred Return serves the alignment of interest concept by linking the Carried Interest to superior performance.”<sup>66</sup> Schell acknowledges that the carried interest may not always reflect superior performance, but he remains unconvinced of its virtue. “From a purely analytical point of view,” he notes, “it is not obvious that no Carried Interest should be payable unless investment returns exceed a specified level.”<sup>67</sup>

Schell defends the status quo by drawing an analogy to the compensation of public company executives. Compensation structures, he explains, do not always impose a requirement that executives exceed a benchmark.<sup>68</sup> “For example,” he continues, “corporations frequently grant stock options to executives and establish the exercise price based on the underlying stock price on the date the option is granted.”<sup>69</sup> Despite the fact that the exercise price is fixed and does not increase over time, “the interests of the executive are considered aligned with those of the shareholders in the sense that the stock must appreciate in order for the option to have value.”<sup>70</sup> Schell recognizes that this approach – by far the most common approach for compensating public company executives – may reward mediocre performance. He explains, “the corporate executive

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<sup>62</sup> See Cole, *Preference for Preferences*, supra note [xx]; Gilson & Schizer, supra note [xx].

<sup>63</sup> See Bebchuk & Fried, supra note [xx]; Jensen & Murphy on compensation committees. Cite to research showing that compensation committees often look to what peer CEOs make.

<sup>64</sup> See Schell, supra note [xx], at § 2.03[1].

<sup>65</sup> See *id.*

<sup>66</sup> See *id.* Schell explains that “[i]nvestors sometimes express this point in negotiations by asking why they should give up 20% of the profits attributable to their capital if a higher return could have been obtained in a money market fund or other low risk investment.” *Id.*

<sup>67</sup> *Id.*

<sup>68</sup> See, e.g., Bebchuk & Fried, supra note [xx].

<sup>69</sup> See Schell, supra note [xx], at § 2.03[1].

<sup>70</sup> *Id.*

participates in the appreciation of the stock on a first dollar basis and his or her incentive compensation is not conditioned upon superior performance.”<sup>71</sup>

To the extent that the purpose of fund agreements is merely to create horizontal equity with public company executives, Schell’s explanation has some merit. But Schell’s analogy does little to explain the difference between venture funds and buyout funds. Both types of funds potentially compete with public companies for talent, and yet only venture funds exclude a preferred return.

More importantly, Schell’s analogy provides no reason for using public company compensation as a model for private equity compensation practices. To the extent that we expect the LP Agreement to align the incentives of investor and manager – a goal we should also maintain for public company executives – Schell’s analogy only removes the puzzle one level higher: is the compensation of public company executives a good model?

Executive stock option practices are deeply flawed.<sup>72</sup> Lucian Bebchuk, Jesse Fried and David Walker argue, for example, that at-the-money options serve as a rent - extraction device, allowing executives to maximize pay while minimizing outrage costs.<sup>73</sup> Central to their argument is the fixed, at-the-money strike price of the typical option package. By failing to index the strike price of the option to industry benchmarks or to account for the time value of the option, options allow executives to camouflage their compensation and avoid incurring outrage costs by offended shareholders.<sup>74</sup> In a recent article, Michael Jensen and Kevin Murphy conclude that corporate boards should consider cost-of-capital indexed options to make executives more sensitive to performance. Because many of the norms and institutional factors that lead to non-indexed options in the public company context are not present in the private equity context, this literature has limited direct application to the puzzle of the missing preferred return.<sup>75</sup> What is clear from this literature, however, is that few commentators would adopt executive stock options to be a suitable model for private equity practices.

## **E. Distorting Incentives**

An industry report by a trade group, Asset Alternatives, provides a promising explanation: perhaps venture funds do not include a preferred return because a preferred return might distort, rather than align, the incentives of the GP.<sup>76</sup> Implicitly, the report

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<sup>71</sup> Schell, *supra* note [x], at § 2.03[1]. Schell goes on to note that the analogy to public company executives may be more compelling “in case of smaller Funds where the fixed compensation of the Principals derived from Management Fees may be less than that of executives with comparable levels of experience in more conventional financial institutions.” I am not sure I understand why this should be the case; just because gross compensation is larger does not make a windfall more efficient.

<sup>72</sup> See Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. Pa. L. Rev. 1901, 1906-08 (2001) (identifying problems with traditional option plans); David M. Schizer, *Indexed Options*; David M. Schizer, *Executives and Hedging*.

<sup>73</sup> See Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. Chi. L. Rev. [pin] (2002).

<sup>74</sup> *See id.*

<sup>75</sup> See Levmore, *supra* note [xx].

<sup>76</sup> See Toll, *supra* note [xx], at 53.

recognizes that the presence or absence of a preferred return term can affect VCs' attitude toward risk. But thinking about the issue is rather muddled. In discussing preferred returns, the report notes that for reasons that are "quite specific to the dynamics of venture capital investing," limited partners "generally have refrained" from seeking preferred returns on venture funds.<sup>77</sup> The report explains that "the primary reason for LP restraint here is the fear of unintentionally distorting the incentives that motivate" the VCs.<sup>78</sup>

The report cites two examples of how a preferred return might distort incentives. First, the report explains, a preferred return term might make VCs too cautious. "The concern is that in order to ensure that they achieve the preferred return goal, a venture capital group might make conservative investments that have limited upside but also quite limited downside."<sup>79</sup> Second, the report explains that if the VCs strike out on its first handful of deals, the added hurdle of a preferred return might lead them to give up hope prematurely.<sup>80</sup>

The first example – making GPs overly cautious – is unpersuasive. The preferred return term has the effect of making the GP less cautious, not more. If the benchmark is raised, the manager must perform better and take more risk to achieve the higher goal. Moreover, it is not clear that it is possible for VCs to be both cautious and yet still confident that they could exceed an 8% return. After all, if safe investments yielding greater than 8% were readily available, one would not need an intermediary to invest. Rather, just the opposite is true: a preferred return eliminates the possibility of GPs sitting back and making safe investments rather than aggressively sourcing investments<sup>81</sup>

The second example – the early strike out example – is more plausible. After a few failures, a GP might become increasingly desperate and make risky, negative net present value investments in the slim hope of landing a big fish. A GP might even abandon a fund with early strikeouts or pay little attention beyond the minimum needed to justify acceptance of the management fee.

If the early strike out problem were the driving force behind the absence of a preferred return, however, one might expect a different solution. The partnership agreement could calculate carry on a deal-by-deal basis, as was done in the early days of venture funds. Alternatively, LPs could volunteer to "re-price" the preferred return, just as public company compensation committees often re-price stock options when the options are deep out of the money.<sup>82</sup> Furthermore, if the early strike out problem were

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<sup>77</sup> *See id.*

<sup>78</sup> *See id.*

<sup>79</sup> *See id.*

<sup>80</sup> *See id.*

<sup>81</sup> *See infra* [section on moral hazard in LBO funds.]

<sup>82</sup> A consistent practice of re-pricing the preferred return might distort ex ante incentives; but then again so does failing to include a preferred return. Eliminating the preferred return distorts incentives in all cases, ex ante, but improves incentives only in a few (those funds that have some early strikeouts). Nor does excluding a preferred return really solve the early strike out problem. All it does is keep an out of the money carry from becoming deeper out of the money over time. Anytime the carry is out of the money, the VC will have an incentive to take more risk than is optimal from the investors' point of view. A better solution would be to give the VC a capital interest rather than a profits interest in the fund.

truly the paramount concern, one might expect GPs to receive a percentage of the fund, not just a percentage of the profits. Giving GPs something to lose on the downside as well as something to gain on the upside would eliminate this distortion of incentives.

The effect of the preferred return on the incentives of the GP is the most promising line of inquiry. Bargaining power, history, cash flow, and horizontal equity offer some superficial appeal but none holds up well under closer scrutiny. Incentives might. The existing literature does little to clarify exactly what incentives the absence of a preferred return creates. Is it intended to make GPs risk averse or to help them overcome risk aversion? If it is intended to change risk preferences over time, then why is it structured with a fixed hurdle rate? I turn to these questions now in Section IV.

#### **IV. The Efficiency (and Inefficiency) of the Preferred Return**

The partnership agreement guides the behavior of the managers and investors. Compensation terms are no exception; contractual provisions regarding VC pay are designed to attract, incentivize, and reward good performance, and to deter and penalize shirking. To understand whether a preferred return would improve incentives, I consider the context of how VCs create value over the life of a fund.

##### **A. Aligning Incentives**

Private equity faces a familiar problem: the separation of ownership and control. LPs contribute capital to the fund but do not directly control the use of the capital, instead relying on the GP to invest on their behalf. Several factors create an incentive for the GP to work hard, find good portfolio companies to invest in, and spend time working with management of these companies to increase their value. These factors include fiduciary duties, management fees, reputation, and the carried interest.

Fiduciary duties do not provide a strong incentive to work hard. In theory, the general partner of a partnership has extremely strong fiduciary duties to its partners. In *Meinhard v. Salmon*, Justice Cardozo explained that partners owe one another "the duty of the finest loyalty. . . . Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."<sup>83</sup> While academics are fond of trotting out Cardozo's famous dictum, this exaggerates the state of the law.<sup>84</sup> The business decisions of GPs are effectively insulated from court review.<sup>85</sup> The common law provides incentives not to lie, cheat, or steal, but not much of an incentive to work especially hard or to be especially talented in the first place.

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<sup>83</sup> See *Meinhard v. Salmon*, 164 N.E. 545, pin (N.Y. 1928).

<sup>84</sup> See Stephen M. Bainbridge, *AGENCY, PARTNERSHIPS & LLCs* 139 (Foundation Press 2004) (noting that even in the duty of loyalty context, it is not necessarily a violation to further one's own interest). See also Ribstein, *Are Partners Fiduciaries?*, (draft available on SSRN).

<sup>85</sup> See *id.* at 176 (noting possible application of business judgment rule in partnership context). In a recent high-profile case, a private equity fund was found to have breached its fiduciary duties by making investments in excess of a contractual cap; the jury, however, refused to award damages, finding that the investors had ratified or acquiesced to the investments. See Weil Goltshal, *Verdict Reached in Connecticut v. Forstmann Little*, available at <http://www.altassets.com/pdfs/weiljuly.pdf>.

The management fee also fails to provide a strong incentive to work hard. GPs typically receive an annual management fee of between one and three percent of the capital committed to the fund.<sup>86</sup> The management fee pays for the administrative expenses of the fund, legal expenses, and pays the handsome salaries of the professionals who work for the GP. The management fee is not contingent on the profitability of the fund. Because the management fee is paid regardless of the performance of the fund, it creates only a weak financial incentive. The only recourse for unhappy LPs is to seek the removal of the GP, a drastic step that is difficult to accomplish under most contracts. If anything, then, the quasi-guaranteed management fee creates an incentive to be somewhat tentative and risk averse; a mediocre GP who follows the herd is unlikely to be ousted absent self-dealing or some other breach that is easier to prove.

Reputation provides a significant performance incentive for some funds. By the third or fourth year in the life of a typical fund, the GP has already begun raising money for its next fund. LPs considering investing in the next fund will conduct considerable diligence on the prior performance of the GP. Nonetheless, reputation is only a partial solution to the agency costs problem. Within the group of professionals that makes up a GP, some individuals may be more talented than others, but performance metrics rarely track the involvement of each individual manager. As an individual works hard and creates value for the fund, his colleagues may share the benefit. An individual who locates a portfolio company that proves successful, however, may see a direct increase in her own compensation, depending on the fund's internal profit sharing rules.<sup>87</sup>

The carried interest thus provides the most powerful incentive to work hard. A large carry is one of the hallmarks of a private equity fund, and it is considered essential to attracting talented managers. While private equity managers could live well on their base salaries alone, they would not be truly rich. Only the massive compensation of the carried interest of a successful fund can do that, and it is the prodigious carry of successful private equity funds that lures professionals away from investment banks, commercial banks and other investment management companies.<sup>88</sup>

## **B. The Option Analogy**

Characterizing the carried interest as an option can help us understand under what conditions the current design of the carried interest in venture funds properly aligns incentives.<sup>89</sup> A carried interest is a derivative and can be analyzed as such to understand the preferences, and thus the incentives, of the derivative holder. A derivative is a financial contract that has a value derived from some underlying security, commodity or

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<sup>86</sup> This amount sometimes decreases in the later years of the fund, when most of the fund's capital has been committed and the expenses of the fund decrease.

<sup>87</sup> Internal GP compensation practices are an even bigger mystery than GP-LP practices. Many GPs appear to adjust carried interest shares according to the involvement of each individual in a particular deal. See Schell, *supra* note [xx], at § 4.04[4].

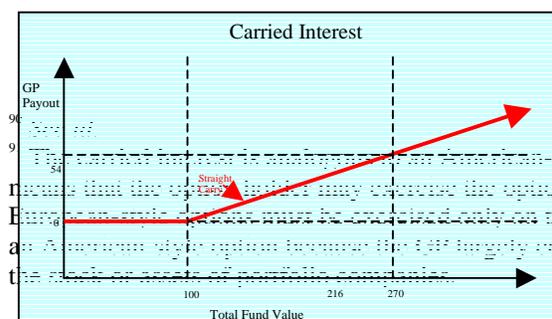
<sup>88</sup> Some VCs who have already achieved financial independence may be motivated more by the psychic satisfaction of creating new technologies and finding the next Google or funding a biotech company that cures cancer. At the margins, though, most VCs remain sensitive to financial considerations. Few, after all, would do this work for free.

<sup>89</sup> See Sahlman, *supra* note [xx].

fact. A stock option, for example, is a derivative that has a value determined by reference to the value of an underlying stock. An interest rate swap is a derivative that rises and falls in value as interest rates go up or down. Here, the partnership agreement is a financial contract, and the value of the carried interest provision of the contract depends on the value of the underlying fund. Thus, it may be useful to think of the carry as a derivative and compare its performance characteristics to other derivatives to understand better how the financial payouts of the carry affect the holder's incentives and attitudes towards risk over time. In this case, the carried interest most closely resembles a call option, a common derivative used in the capital markets.<sup>90</sup> A call option gives the holder the right, but not the obligation, to buy a fixed amount of the underlying for a fixed price and some point in the future.

To be more precise, a 20% carry is financially equivalent to a call option on 20% of the value of the fund.<sup>91</sup> The holder of the carried interest, like the holder of a call option, enjoys the possibility of theoretically unlimited upside gain but bears no risk of loss. If the fund increases in value, the GP shares in the profits, just as would happen when an option holder exercises an option. If the fund loses value, the GP has neither gain nor loss, again, just like an option holder who declines to exercise an option.

A numerical example may help illustrate the analogy. A 20% carried interest is financially equivalent to a call option on 20% of the value of the fund, with a fixed exercise price equal to 20% of the initial investment in the fund. Consider a fund with an initial capital amount of \$100. If the fund appreciates to \$400, the GP has the right to call 20% of the fund (20% of \$400, or \$80) at a strike price of 20% of the initial capital amount (20% of \$100, or \$20). The difference between the current market value of the option (\$80) and the strike price (\$20) represents the GP's profit (\$60). This \$60 profit on the option is equivalent to a carried interest of 20%, as a carry of 20% of the overall profits of the fund, or \$300, is also \$60. The analogy holds on the downside: if the value of the fund declines below its initial value, the carried interest has no current liquidation value, just like the holder of an out of the money call option.



The option analogy is useful because it allows us to tap into the extensive research

on the call option on common stock. American-style options can be exercised at any time before the expiration expires, while European-style options can only be exercised at the fixed expiration date. The carried interest resembles a European-style option because the GP largely controls when the fund realizes its investments by selling

on executive compensation in the context of public company executives. Executives of public companies typically receive a pay package that includes a cash salary and stock options; the options typically have a strike price at the money and a ten-year term. Few academics believe that this package is ideal: reform proposals include the use of indexed options and replacing options with restricted stock.

To index an option means resetting the strike price according to a formula. For example, one might set the strike price of an option to move along with a basket of stock prices. An executive at Delta Airlines, for example, might receive options with a strike price based on an index of the stock prices of American, United, and Continental. If the whole airline industry falls upon hard times, pushing all airline stocks down, but Delta weathers the storm better than its competitors, then the strike price of the option drops along with the basket, allowing the Delta executive to be rewarded for her superior performance relative to her peers at other airlines. If airline stocks soar but Delta falls behind, the executive will not be rewarded.<sup>92</sup>

A second type of indexed options, cost-of-capital-indexed-options, moves the strike price higher over time to reflect the company's cost-of-capital.<sup>93</sup> Thus, if the company's cost of capital (the amount of interest or expected return it must pay to raise additional money in the capital markets) is 10%, the strike price of the executive's option will increase by 10% per year. If the company's stock price rises slowly, but does not match the investors' expected return, then the executive will not be rewarded.

Options, whether indexed or not, have a significant drawback: when they are out of the money, they can induce overly risky behavior on the part of the executives. Imagine an executive with options with a strike price of \$100 and one year remaining until expiration. Now suppose that the stock is currently trading at \$50, and the executive is setting the corporate strategy for the upcoming year. If the company does well but not spectacularly well, the executive will not be rewarded; only if the company doubles its stock price will the executive receive anything. The executive may become overly risk-seeking, then, taking unwise gambles, even if such gambles have a negative net present value to the shareholders.

Some critics of stock options have suggested that executives should receive restricted stock rather than stock options.<sup>94</sup> Restricted stock can improve incentives between the shareholders and the executive by giving the executive something to lose on the downside as well as something to gain on the upside, just like shareholders.<sup>95</sup> A drawback of restricted stock, however, is that it may not work well for risk averse executives, who may become too focused on preserving value rather than creating additional value in the firm.

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<sup>92</sup> For a discussion of indexed options, see Levmore, *supra* note [xx]; Bebchuk & Fried, *supra* note [xx].

<sup>93</sup> See G. Bennett Stewart, *Remaking the Corporation from Within*, 68 HARVARD BUS. REV. 12-13 1990

<sup>94</sup> See Jensen & Murphy and cites therein.

<sup>95</sup> Restricted stock may also appeal to executives who demand a high risk premium with options, thereby allowing companies to save on overall compensation. See Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. Acct. & Econ. 3, 37 (2002).

How does the carried interest compare to executive stock options? The carried interest is equivalent to a call option with an at-the-money strike price. A carried interest with a true preferred return is equivalent to a cost-of-capital indexed option. Restricted stock is not equivalent to any type of carried interest at all, but rather to a capital interest in the partnership. The analogy is easy; the hard part is figuring out exactly what this means for venture funds. I turn now to this task.

### **C. The Efficiency and Inefficiency of the Preferred Return**

There are tradeoffs, even in a world without taxes. When pay is contingent on performance, VCs have a stronger incentive to succeed. But because the success of a fund is not entirely within their control, VCs demand a risk premium when their pay is contingent. Paying for mediocre performance is a bad deal, but risk premium makes paying for performance costly in a different way. Pay should be linked to performance if, but only if, linking them together increases the expected value of the fund above and beyond the amount of risk premium paid to the VC.<sup>96</sup>

To get better traction on this question of efficient compensation design, I focus on two areas where financial incentives may stimulate better performance: deal flow and deal harvesting. Deal flow relates to the VC's ability to find good portfolio investments. Deal harvesting relates to the VC's ability to bring those investments to a successful exit. Because not all venture firms are the same – VCs have different reputations, abilities, and risk tolerance – there may not be a single optimal compensation design. But we can nevertheless draw some conclusions about the relative efficiency and inefficiency of different compensation schemes through closer examination of the context in which VCs perform their duties for investors.

#### **1. Assumptions**

It may be useful to spell out my assumptions about what makes a certain compensation design efficient. I make four assumptions. First, I assume that VCs are motivated in part by financial incentives. Perhaps some VCs are rich enough that they would work for free. But the ubiquity of the carried interest suggests that money influences VCs' decisions about how much effort to expend choosing, advising and monitoring companies.

Second, I assume that some VCs have better reputations than others, and that investors can discover these reputations at low cost. Reputation is important in many business contexts, but perhaps especially so in venture capital. Sand Hill Road is a tight-knit community, and word gets around quickly.<sup>97</sup> VCs network with entrepreneurs, investors, and amongst themselves, in person, by email, and on blogs.

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<sup>96</sup> See generally Jensen & Murphy, *supra*.

<sup>97</sup> Dozens of venture capital funds are located on the same road, Sand Hill Road, near Palo Alto. This not only facilitates networking and allows them to keep a close eye on the portfolio companies they invest in; it also creates a community where word gets around and monitoring VC behavior is relatively easy for investors. See ANNA LEE SAXENIAN, *REGIONAL ADVANTAGE*; Ronald J. Gilson, *The Legal Infrastructure of High-Tech Industrial Districts: Silicon Valley, Route 128, and Covenants not to Compete*, 74 NYU LAW REV. 575 (1999).

Third, I assume that VCs value their reputations and can be expected to try to act in ways that will preserve their reputations. Reputational constraints are powerful because investors are repeat players. Institutional investors such as pension funds, university endowments and insurance companies return to the venture capital market again and again, and are in a position to punish VCs who misbehave by refusing to invest in their next fund.<sup>98</sup>

Lastly, I assume that VCs are risk averse. Venture capitalists hardly fit the stereotype of a Nervous Nelly. VCs are stereotyped as free-wheeling innovators who like risk for its own sake. They are the cowboys of the investment world. But the cultural stereotype may be a bit of an exaggeration. VCs take calculated risks, and they do so with other people's money. There is little reason to think that when it comes to their own personal finances, VCs behave all that differently than other executives. Like everyone else, VCs enjoy decreasing marginal utility from each additional dollar that they earn. For highly successful VCs, this may just mean that their first private jet is more dear than their second. But most VCs have a salary structure similar to atypical investment banker.<sup>99</sup> Venture capitalists have high recurring expenses for mortgage payments, car payments, private school tuition, and the like. Given a choice between \$10 million over the next ten years or a 50-50 shot at \$21 million, most VCs would choose the sure thing. VCs cannot diversify away their firm-specific risk, and so they demand a risk premium when compensation is tied to firm performance.<sup>100</sup>

## 2. Deal Flow Incentives

With these assumptions in mind, I turn now to the context of how VCs create value to consider whether the carried interest properly aligns incentives. VCs are not passive money managers. They create value for their investors by locating good portfolio companies, choosing well among possible investments, and negotiating favorable investment terms. This activity in the early years of a fund's existence can all be bracketed as relating to "deal flow." Deal flow comes easy to elite VCs. When entrepreneurs seek funding for a new idea, they turn first to the royalty of Silicon Valley: Kleiner Perkins, Sequoia, Benchmark, and other elite venture funds. Entrepreneurs know

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<sup>98</sup> Cite to Gilson, Gompers.

<sup>99</sup> On the surprising stress of maintaining a wealthy lifestyle, see TOM WOLFE, *BONFIRE OF THE VANITIES*.

<sup>100</sup> Research by financial economists supports the assumption that VCs are risk averse. A model by Professors Charles Jones and Matthew Rhodes-Kropf finds that a straight carried interest best aligns the incentives of the risk averse VC with the principals. See Charles M. Jones & Matthew Rhodes-Kropf, *The Price of Diversifiable Risk in Venture Capital and Private Equity*, available on SSRN, May 2003 version, at 5. A capital interest would encourage VCs to diversify away some firm-specific risk by investing in too many portfolio companies. A straight carried interest, by rewarding the VCs for volatility, moderates the risk aversion. A preferred return, however, would go too far, encouraging too much risk-taking at the cost of returns. *Id.* at 23. The Jones-Rhodes-Kropf model is useful, but fails to fully answer the question at hand, which is why LBO funds are subject to preferred returns, but VCs are not. Some of their assumptions, moreover, are questionable as they pertain to the question at hand. For example, they assume that VCs are not limited in the number of projects they can invest in. *Id.* at 7, n.12. By contract, however, most VCs cannot invest in more than [x] projects. It is possible, then, that it may be more efficient to compensate VCs with a capital interest, and address the over-diversification problem with a contractual restriction. Moreover, the model fails to reflect the impact of taxes, which may distort the incentive effects considerably, as I discuss below.

these well-established funds can provide valuable capital, management expertise, customer contacts and executive staffing contacts to help the company grow. With talented entrepreneurs knocking at the door, high-reputation VCs can be choosier about which deals they fund, and they might be able to negotiate better terms. Lesser known VC funds can also achieve good deal flow, but they must work a bit harder to get it. VCs do this by attending technology conferences, networking with entrepreneurs and other VCs, studying developing technologies and industries, working with university researchers, and so on.<sup>101</sup>

Deal flow sometimes refers only to the rate at which firms receive potential offers of investment. I use the term more broadly to encompass not just receiving a high number of potential deals, but also to refer to the quality of the deals and the VCs' ability to turn those potential deals into actual closings with attractive deal terms. Venture capitalists exercise discretion in choosing projects and negotiating the terms of investment. The due diligence process has become more important in recent years. Before investing, VCs often interview everyone they reasonably can, including founders, managers, suppliers, and customers. VCs must research the relevant markets and competition to assess the portfolio company's likelihood of success.

The ability to secure good deal flow is especially important in market environments where there is "money chasing deals." VCs today report a scarcity of ideas and entrepreneurs relative to the amount of money that continues to flow into the venture capital sector. As one practitioner explained it, "God grades on a curve."<sup>102</sup> A thin market for entrepreneurs creates a moral hazard risk: VCs will be tempted to invest all of the committed capital, even if not every investment is likely to be profitable. In particular, VCs with weak networks may have trouble sourcing deals and may accept the first proposals to come along, regardless of their likelihood of success. Even for VCs with strong deal flow, accepting proposals quickly might allow the VCs to turn their attention to other tasks, like raising money for their next fund.

A preferred return can help align the deal flow incentives of the VC with the goals of their investors. If compensation is contingent on exceeding a preferred return, VCs are more likely to invest only in companies that are likely to exceed this return. To address the parallel concern in the public company context, Professors Jensen and Murphy argue that companies should consider giving executives cost-of-capital indexed options.<sup>103</sup> A cost-of-capital indexed option addresses the opportunity cost when executives invest money in deals that offer subpar returns; it would be more efficient if they returned the money to the investors to allow them to invest elsewhere. By raising the strike price over time, cost-of-capital indexed options make executives aware of the hurdle rate they must achieve to satisfy investors, and it gives them the financial incentive to do so.

Extending this model to the venture capital context is tricky. Context matters; VCs may not face the same choices that public company executives face. To understand

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<sup>101</sup> For an empirical study on the importance of VC Networking, see Yael Hochberg, Alexander Ljungqvist & Yang Lu, Who You Know Matters: Venture Capital Networks and Investment Performance (draft Dec. 2004, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=631941](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=631941)).

<sup>102</sup> David Chen, Willamette Conference.

<sup>103</sup> See Jensen & Murphy, *supra* note [xx].

the impact of compensation design on deal flow incentives, I consider four possible compensation designs: a true preferred return, a hurdle rate, a straight carried interest with no preferred return, and a capital interest in the partnership. Other compensation designs are possible: one could imagine a tiered carried interest where the percentage of the carry increases as the amount of profits increase. For example, VCs could receive 10% of the first \$10 million in profits, 20% of the next \$10 million, and 30% of any additional profits. Or one could imagine a carried interest that is indexed to the performance of peer funds. For (relative) simplicity, however, it seems useful to consider the efficiency of the most common compensation schemes – a hurdle rate and a straight carried interest – and two closely related schemes that seem to improve efficiency over the status quo – a true preferred return, and a capital interest in the partnership.

If encouraging VCs to create good deal flow and to properly exercise discretion in funding projects is the paramount goal, then a true preferred return appears to be more efficient than the alternatives.<sup>104</sup> A preferred return rewards VCs with a share of the profits only to the extent they choose projects that exceed the investors' cost of capital. When VCs find companies that seem unlikely to meet the necessary return, they will have an incentive to engage in further networking to find better alternatives.

Buyout funds' use of an 8% preferred return thus seems to reflect investors' concerns about how fund managers choose portfolio companies. At the same time, if the goal is to create the financial equivalent of a cost-of-capital indexed option, then the industry standard hurdle rate of 8% used by many private equity funds seems rather arbitrary. An investor's cost of capital might be lower or higher than this amount, and would be expected to vary as interest rates rise and fall. It may be that the common use of 8% as a hurdle rate reflects the peculiar nature of venture capital and private equity, where many investors are pension funds. The 8% number may have originated by a demand by pension funds, which often use a discount rate of 8% to calculate their future liabilities.<sup>105</sup> To the extent private equity investments can clear this discount rate, pension fund managers are achieving the return necessary to improve the financial security of their own principals.

While a preferred return can improve deal flow incentives, this increase in efficiency comes at a cost. Because the carried interest starts "later", i.e., at a higher strike price, VCs will demand a higher percentage of carried interest so that if they do exceed the expected return, they are compensated at least as well as if they had received the straight carried interest. Investors might have to offer VCs a higher percentage of the profits – say, 30% instead of 20% -- to get them to accept the true preferred return. If aligning deal flow incentives increases the likely total return by a sufficient amount, then investors should be willing to pay a higher percentage of carry, since aligning the incentives will nonetheless increase the net present value of their investment in the fund.

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<sup>104</sup> Risk aversion makes the optimal design difficult to figure out, even if deal flow incentives are the only goal and tax consequences are ignored. Because VCs are risk averse, they will value the first dollars of carry that they receive more than the additional dollars, and thus may work harder to clear the hurdle and worry less about by how much they clear the hurdle. A preferred return with a tiered carried interest rate might be more efficient.

<sup>105</sup> Interview with Carrie McCabe, McCabe Advisors LLC, at Georgetown University Law Center, Fall 2004. [follow up by email]

Risk aversion complicates the analysis further. Risk aversion will lead even VCs who are confident in their abilities to demand an additional risk premium if their compensation is subject to a true preferred return. Even superbly talented VCs face uncertainties with any portfolio company, ups and downs in the market, and an exit strategy that depends in part on a vibrant IPO market. Fund agreements limit the range of companies that VCs can invest in, making diversification difficult and increasing firm-specific risk. Investors might have to offer VCs an even higher percentage of the carry, perhaps 35%, in order to compensate the managers for the increased risk associated with the preferred return. Nonetheless, the trade-off may be a good one if the investors need assurance that the managers they are hiring are competent.<sup>106</sup>

A formal model of optimal compensation design for risk averse venture capitalists is beyond the scope of this Article. For present purposes, it is sufficient to recognize that because investors must compensate VCs for the increased risk associated with making a carry subject to a true preferred return, the preferred return is a somewhat costly device to screen talent and manage the agency cost problem. For some funds, then, relying on reputation may be a more efficient solution. Investors in prestigious funds can be confident that the VCs will have little trouble finding good deals and choosing the pick of the litter. Because venture funds will want to preserve their reputation to aid in future fund raising efforts, investors can have some confidence that VCs with strong reputations will get them into the right investments. Because the risk aversion of VCs makes a preferred return costly, we would expect to see it employed only when deal flow incentives are paramount. The institutional quirks of the venture capital industry, with relatively small networks of entrepreneurs, VCs, and investors, create a plausible story that investors in funds with strong reputations have no need to employ a true preferred return.<sup>107</sup>

Deal flow incentives can thus help us understand why some venture capital funds might use a preferred return. But the few VC funds that do employ a preferred return use a hurdle rate, not a true preferred return. Why? Recall that VCs will demand a risk premium in exchange for giving investors a preferred return. A hurdle rate may be more efficient than a true preferred return if it properly aligns deal flow incentives but is less risky for VCs. And a hurdle rate does help align deal flow incentives. VCs who are not confident that they can clear 8% will value their compensation less, and will look for other work. And a hurdle rate, like a true preferred return, encourages VCs to choose investments that in the aggregate will clear 8%.

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<sup>106</sup> One recent model in the public company context finds that, after accounting for executive risk aversion and effort aversion, at-the-money or in-the-money options are optimal. See Oded Palmon, Sasson Bar-Yosef, Ren-Raw Chen & Itzhak Venezia, *Optimal Strike Prices of Stock Options for Effort Averse Executives* (draft available on SSRN). The impact of risk aversion should not be overstated, however. VCs also receive some compensation in the form of management fees, which are not contingent on the performance of the fund. Because VCs receive some riskless return, the additional compensation in the form of carry may not be discounted for risk as steeply as one might think at first glance.

<sup>107</sup> See Daniel Covitz & Nellie Liang, *Recent Developments in the Private Equity Market and the Role of Preferred Returns* (available on SSRN) (Jan. 2002 draft) at 17 (finding that preferred returns are more common at young firms, thus suggesting a screening effect).

But a hurdle rate introduces a new distortion. Imagine that a VC is considering three deals: a low-risk, low-return company that will return \$105 in one year on a \$100 investment, a medium-risk, medium-return company that has a 80% chance of returning \$110, but has a 20% risk of returning \$105, and a high risk, high-return company that has a 20% chance of returning \$130, but has an 80% risk of returning \$105. A risk neutral investor would prefer the high-risk, high-return option, as it maximizes the expected return. A hurdle rate, however, does not lead the VC to choose this option.<sup>108</sup> The hurdle rate screens out the low-risk, low-return, option, but it allows the manager to receive its full share of carry on either the successful medium or high risk investment. Because the catch-up provision allows the manager to gain its full share of carry as the return of the fund moves from 8-10 percent, the manager may concentrate on clearing the hurdle rather than maximizing total value. VC risk aversion may magnify the distortion. Assuming a declining marginal utility of wealth, the medium-risk, medium return strategy will be even more appealing than the high-risk, high-return strategy.<sup>109</sup>

A straight carried interest provides weaker deal flow incentives than a true preferred return or hurdle rate. Risk-averse managers no longer have an incentive to reject even low-risk, low-return investment opportunities. A sure thing that achieves a 6% return will be attractive, even though this is not the sort of bet their investors have in mind. This moral hazard risk should not be overstated: one may address this concern in ways other than compensation design. Venture capital fund agreements routinely limit by contract the sorts of companies that the fund may invest in. For example, a fund may be limited to making investments in early-stage computer software companies. While one might find both medium-risk and high-risk companies, one is not likely to find a low-risk early-stage computer software company to invest in. Thus, a straight carried interest may be nearly as effective as a true preferred return in encouraging good investments. A straight carried interest does have a significant weakness, however, when it comes to screening out bad VCs. Few VCs are unable to achieve a positive return, and so few will be deterred by a compensation scheme that rewards performance even when that performance is subpar.

A capital interest in a partnership provides the weakest deal flow incentives. It provides no screening effect; even the worst VCs will not destroy the entire value of the fund. Moreover, a capital interest in a partnership may encourage VCs to shy away from risky investments. The compensation curve is upward sloping, so there is an incentive to

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<sup>108</sup>	Expected Fund Return	Expected GP Payout
Low-Low	\$5	0
Medium-Medium	\$9 (10(.8)+5(.2))	\$1.60 (10(.8)(.2)+0(.2))
High-High	\$10 (5(.8)+30(.2))	\$1.20 (0(.8)+30(.2)(.2))

<sup>109</sup> But the distortion caused by the catch-up zone may be less important in practice than it appears. It would be difficult at the outset for VCs to distinguish between medium-risk and high-risk projects. If a VC cannot distinguish between the two, then it will simply choose the best projects. Moreover, the hurdle rate is calculated based on aggregate returns to date, so the strategy that maximizes net present value will also usually maximize the chances of clearing the hurdle.

source and fund companies with a higher expected return. Because VCs are risk averse, however, at the margins they may shy away from riskier investments.

In sum, for funds where deal flow incentives are important, equity based compensation should offer VCs no reward for investments that do not return at least the investors' cost of capital. A true preferred return achieves this goal. A straight carried interest does not. Reputation effects may mitigate some of the concerns about deal flow incentives. Opportunity costs may provide a substantial constraint on a VC's choice of projects. When an investor makes a capital commitment to a fund, the commitment is capped at a certain amount. Thus, even a VC who has a capital interest in a partnership (and thus will make money from any investment) has an incentive to turn down deals if she is confident that better deals will come along within the funds' investment time frame. Opportunity costs are highest for VCs with better reputations, who have the strongest deal flow.<sup>110</sup> Thus, providing strong deal flow incentives are most important for VCs who have the weakest deal flow and so might be more inclined to accept whatever deals they can find.

### **3. Deal Harvesting Incentives**

The work of venture capitalists is not finished after they invest in portfolio companies. VCs are active investors. They often sit on the board of the portfolio companies, and sometimes even control the board. Even without board control, VCs exert power over the portfolio companies by threatening to withhold financing for additional rounds of investment. They provide entrepreneurs with management consulting advice, tap into their network of contacts to provide executive staffing, find relationships with customers, and aid in strategic planning.

To encourage VCs to maximize the value of the portfolio companies, it may be important to give them both something to gain on the upside and something to lose on the downside. The importance of upside is obvious: if VCs earn more by increasing the value of the portfolio companies, they will work harder and will pay more attention to harvesting investing deals than to raising money for their next fund. The importance of having something to lose on the downside is less obvious, but significant. If VCs have nothing to lose, they may encourage portfolio companies to make risky bets. VCs may do this by encouraging portfolio companies to go public before they are ready, to roll out products without sufficient testing, or to spend more money on marketing rather than R&D.

This effect is not unique to the carried interest. Any option-like compensation, including the common stock of a highly leveraged firm, shares this drawback. When an option is out of the money, the holder has an incentive to take big risks with the company, even if such risky moves have a negative net present value.

The problem may be more pronounced in VCs funds than in other contexts. The value of venture funds is subject to a "J-curve" effect: the value typically declines in the

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<sup>110</sup> I assume that VCs who have a strong reputation with investors also have a strong reputation among entrepreneurs seeking funding.

early years of a fund, and then increases later.<sup>111</sup> If the carry is far enough out of the money, the VC may simply give up on the fund, instead shifting attention to raising money for the next fund and letting the existing investments languish.

A preferred return or hurdle rate exacerbates the out-of-the-money distortion. Because the strike price increases over time, VCs will face stronger and stronger incentives to make risky, negative net present value bets when offering advice to entrepreneurs.

A hurdle rate introduces an additional inefficiency through the catch-up provision. Suppose a fund has one remaining portfolio company, Epsilon Corp. The LPs originally contributed \$100 to the fund and have received back, to date, \$216. The GP is right at the cusp of clearing the hurdle rate. Now the fund is presented with an offer to sell its Epsilon stock for \$30; alternatively, it could hold on to the stock for another year. If it holds on to the stock, there is a 25% chance Epsilon will go public and the stock would be sold for \$180, and there is a 75% chance of failure, in which case they will receive nothing. This should not be a close call. The IPO play has a present value of \$45; the sale would net \$30.<sup>112</sup> For the GP, though, incentives push it to sell. Every dollar from the sale would be allocated to the GP; the LPs would receive nothing. If Epsilon goes public, on the other hand, the first \$54 would be allocated to the GP, and the remaining \$126 would be split 80-20 in favor of the LPs, leaving the GP with an additional \$21 and a total of \$75. Given the 75% chance of failure, the present value of the IPO play, to the GP, is \$19, far less than \$30 from the sale. The GP, then, might opt for the safer exit. Of course, it is possible that this situation rarely comes up in the real world. GPs, moreover, might enjoy more fund-raising value from a high profile IPO than a quiet sale, implicitly pushing up the value of the riskier strategy. Still, the use of catch up provisions is puzzling from a governance perspective.<sup>113</sup>

The ready availability of alternatives makes the use of catch up provisions especially troubling. Practitioners sometimes say that they do not want to “slow down” the carry beyond the 8% hurdle; a 100% catch up provision certainly speeds up the carry to 20% as quickly as possible. Nonetheless, a tiered carry could accomplish much the same goal without distorting incentives as badly.<sup>114</sup>

A straight carried interest is somewhat more efficient than a preferred return with respect to deal harvesting incentives. A straight carried interest will sometimes suffer from the same distortions that all option-like instruments share: distorted incentives when the option is out of the money. Because the straight carry has a lower strike price, however, it is less likely to fall out of the money, and less likely to be deep out of the money, when the distortion of incentives is the greatest concern.

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<sup>111</sup> See Bartlett & Swan, *supra* note [xx].

<sup>112</sup> [show calculations].

<sup>113</sup> A partial fix is to slow down the catch up provision by allocating 50% of profits to the GP rather than 100% during the catch-up period. This extends the distorted area of return on the graph, but better aligns incentives during the distortion.

<sup>114</sup> For example, based on an initial investment of \$100, the GP could receive 5% of profits from \$100 to \$150, 10% of profits from \$150 to \$200, 15% of profits from \$200 to \$250, and 20% of profits thereafter.

Does deal harvesting solve the puzzle of the missing preferred return? Not quite. If the paramount goal of investors is to eliminate the possible bad incentives of an out of the money carry, the logical solution would be to lower the strike price, or to eliminate the option-like feature of the carry altogether. One would do this by replacing the carried interest with a capital interest in the partnership. A capital interest in the partnership eliminates the distortions of the carried interest. Because VCs have something to lose on the downside and something to gain on the upside, incentives between VCs and investors are more closely aligned. Risk-averse VCs, however, may act in too conservative a manner. Investors concerned about risk aversion might consider increasing the amount of equity-based compensation as returns increase, for example, by giving VCs an additional 2% of the fund for every 10% increase in the IRR.

#### **4. Summary**

The relative efficiency of the carried interest vs. the preferred return depends largely on the reputation of the VCs. If investors are confident that the VCs are talented and will secure good deal flow, then providing good deal harvesting incentives are most important. The option-like characteristic of the carried interest is especially troublesome when one adds in a preferred return. A straight carried interest still distorts deal harvesting incentives, but not as frequently, and even less frequently for funds that have fewer strikeouts. A capital interest aligns deal harvesting incentives best, and thus makes the most sense for high-quality, high-reputation VCs.

If investors are less confident about the talent of the VC and its ability to secure good deal flow, then using a true preferred return may be optimal. Bad managers will value this contingent compensation less than good managers, and will self-select away. Furthermore, managers will be more highly motivated to source high quality deals, knowing that their performance compensation depends on clearing the benchmark. A hurdle rate also provides good screening effects, but introduces additional deal harvesting incentives.

One would expect, then, to see a clientele effect. For established institutional investors who can get into the most prestigious funds, one would expect VCs to receive a capital interest in the fund. In less prestigious funds, on the other hand, one would expect VCs to receive a true preferred return. And yet we see neither of these designs in the real world. No funds that I know of give VCs a capital interest in the fund beyond the traditional one percent of the fund that VCs contribute. When a carried interest is used, it is rarely (in VC) subject to a preferred return. And when a preferred return is used, it is usually a hurdle rate rather than a true preferred return.

How can I explain this gap between my theoretical, agency costs-based predictions and what we observe in the real world? In the public company context, commentators have pointed to managerial power and accounting rules as the likely cause of inefficient contract design. Here, accounting rules are irrelevant, and managerial power seems to be a less compelling story. There is little reason to believe that agency costs would be absent in buyout funds, where preferred returns are used, but absent in venture, where they are not. What is left to explain the puzzle? When optimal

contracting theory fails, solutions tend to fall into two categories: market failures (such as monopolies or excessively high information costs), or legal or regulatory rules that dictate the suboptimal contract design. Here, it is a set of legal rules – tax – that click this Rubik’s Cube into place.

## **V. A Tax Explanation for the Missing Preferred Return**

Tax provides the final move to solve the puzzle. Absent tax, one would expect to see either a true preferred return or capital interest, depending on the reputation of the VC. For VCs with mixed or unknown reputations, one would expect to see a true preferred return. VCs with high reputations should simply receive a capital interest in the partnership, which properly aligns deal harvesting incentives. But we observe neither of these designs in the real world. Arguably, a straight carried interest may represent a balancing act between deal flow incentives and deal harvesting incentives. But incentives alone cannot account for the complete absence of VCs compensated with a capital interest. Nor can incentives account for the nearly universal preference of hurdle rates over true preferred returns. Either investors misunderstand how incentives work, or something else is going on. Tax, ironically, helps bring the picture into focus.

Tax distorts the contract design in two ways. First, management fees are treated as ordinary income and taxed upon receipt. Carry, on the other hand, is treated as capital gain and taxed at a lower rate. Tax thus creates an incentive to pay as much compensation as possible in the form of carry rather than management fees. Second, the value of the carry is not taxed upon receipt of the contract, but rather only when the underlying gains have been realized and distributed. The option value of the carried interest is never taxed. And so in two ways tax creates an incentive to pay as much compensation as possible in the form of carry and as little as possible in the form of management fees

The tax law thus subsidizes compensation for venture capitalists, but only when it comes in the form of carried interest. The subsidy is especially valuable in venture capital because of the volatility of venture funds. Including a preferred return in venture capital contracts (or, for that matter, indexing the carry to an industry benchmark or otherwise increasing firm-specific risk) would reduce the value of the carry, thereby failing to take full advantage of the subsidy. The lawyers and principals who draft partnership agreements quite rationally take full advantage of the tax subsidy at the cost of somewhat inferior contract design.

### **A. The Tax Treatment of Carry**

The tax law creates a gap between the economics of the carried interest and its treatment for tax purposes.

#### **1. Timing**

The first issue is timing. At the moment a fund agreement is signed, the GP receives something of economic value. The carried interest has an option value linked to the likelihood that the value of the fund will increase. To be sure, the option value is

uncertain, contingent as it is on the efforts of the GP and subject to all sorts of external risks, such as the strength of the IPO market. But it has some economic value nonetheless. From a purely economic standpoint, then, the GP should recognize some amount of taxable income at the moment the partnership agreement is signed. But the calculation of the option value would be very difficult to make, and even harder for the IRS to evaluate and police.

Tax practitioners and academics have struggled for years over the problem of the taxation of the receipt of a partnership interest in exchange for services.<sup>115</sup> Partnership interests are often analytically divided into two types: capital interests and profits interests. A profits interest is an interest that gives the partner certain rights in the partnership (thus distinguishing it from an option to acquire a partnership interest) but that has no current liquidation value. A capital interest both gives the partner certain rights in the partnership and also has a current liquidation value. When a partner receives a capital interest in a partnership in exchange for services, the partner has immediate taxable income on the current value of the interest.<sup>116</sup> Determining the proper treatment of a profits interest is more difficult, however, as its current economic value is difficult to determine. In the 1974 case *Diamond vs. Commissioner*, the Tax Court (affirmed by the Seventh Circuit) surprised practitioners by holding that the receipt of a profits interest “with determinable market value” is taxable income.<sup>117</sup>

Prior to *Diamond*, most practitioners felt safe in advising clients that a receipt of a profits interest was not taxable. Even after *Diamond*, practitioners could point to the fact that a profits interest in a partnership rarely has a determinable market value. Some uncertainty remained, however, until 1993, when the IRS settled the issue by conceding that profits interests would not be taxed currently, and by further establishing that a partnership interest with no current liquidation value would be the hallmark of a profits interest. In this pronouncement, Revenue Procedure 93-27, the IRS announced that the IRS would not treat the receipt of a profits interest by a person who performs services to a partnership in a partner capacity as a taxable event for the partner or the partnership.<sup>118</sup>

Rev. Proc. 93-27 spelled out the limits of this safe harbor. To qualify, the profits interest must not relate to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, must not be disposed of within two years of receipt, and the partnership must not be publicly traded.<sup>119</sup> Rev. Proc. 93-27 defines a capital interest as an interest that would

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<sup>115</sup> See, e.g., Martin B. Cowan, *Receipt of an Interest in Partnership Profits in Consideration for Services: The Diamond Case*, 27 TAX L. REV. 161 (1972); MCKEE, NELSON & WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS*, (3d ed. 1997) at ¶ 5.01-5.10; Laura E. Cunningham, *Taxing Partnership Interests Exchanged for Services*, 47 TAX L. REV. 247 (1991); Schmolka, *Taxing Partnership Interests Exchanged for Services: Let Diamond/Campbell Quietly Die*, 47 TAX L. REV. 287 (1991).

<sup>116</sup> See, e.g., *Mark IV Pictures, Inc. v. Commissioner*, 60 T.C.M. 1171, 1176 (1990); *Larson v. Commissioner*, 55 T.C.M. 1637 (1988); *Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980). See also Treas. Reg. §1.721-1(b)(1) and Prop. Treas. Reg. §1.721-1(b)(1)(i).

<sup>117</sup> See *Diamond v. Commissioner*, 56 T.C. 530 (1971), aff'd 492 F.2d 286, 291 (7<sup>th</sup> Cir. 1974).

<sup>118</sup> See Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>119</sup> See *id.* See also Rev. Proc. 2001-43, 2001-2 C.B. 191 (holding that a profits interest that is not substantially vested does trigger a taxable event when restrictions lapse; recipients need not file protective 83(b) elections).

give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership.<sup>120</sup> A profits interest is defined as a partnership interest other than a capital interest.<sup>121</sup> The determination as to whether an interest is a capital interest generally is made at the time of receipt of the partnership interest.<sup>122</sup>

The typical carried interest in a venture capital fund slips cleanly but snugly into the 93-27 safe harbor. The interest has no current liquidation value; if the fund were liquidated immediately, all of the paid-in capital would be returned to the LPs. And while the carried interest has value, it is not related to a "substantially certain and predictable stream of income from partnership assets." On the contrary, the amount of carry is highly uncertain and unpredictable.

Rev. Proc. 93-27 draws an arbitrary line between capital interests and profits interests at whether the interest has a current liquidation value. While the approach has some intuitive appeal and some administrative advantages, there is no economic distinction between a capital interest and a profits interest that would justify taxing them differently when issued to a partner in exchange for services rendered.<sup>123</sup> By ignoring the option value of partnership interests with no current liquidation value, 93-27 allows partners to receive tax-deferred compensation. Because options are more valuable when volatility increases, 93-27 is especially valuable for partnerships that make highly risky investments – like venture capital.

The tax law thus sets up a significant timing benefit for venture capitalists by deferring tax on their compensation so long as the compensation is structured as a profits interest and not a capital interest in the partnership.<sup>124</sup> But there is more than timing at issue: tax also distorts the contract design by treating the carried interest as investment income rather than service income, and thus often allows the character of realized gains to be treated as capital gain rather than ordinary income.

## 2. Character

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<sup>120</sup> See Rev. Proc. 93-27, 1993-2 C.B. 343.

<sup>121</sup> See *id.*

<sup>122</sup> See *id.*

<sup>123</sup> See Cunningham, *supra* note [xx], at 252.

<sup>124</sup> The net result is also more advantageous than parallel rules for executive compensation with corporate stock. See William R. Welke & Olga A. Loy, *Compensating the Service Partner with Partnership Equity: Code § 83 and Other Issues*, at 17 ("The treatment of SP's receipt of a profits interest under Rev. Proc. 93-27 is significantly better than the treatment of an employee's receipt of corporate stock. While the economics of a profits interest can be approximated in the corporate context by giving investors preferred stock for most of their invested capital and selling investors and the employee "cheap" common stock, the employee will recognize OI under Code §83 equal to the excess of common stock's FMV (not liquidation value) over the amount paid for such stock. In addition, if the common stock layer is too thin, there may be risk that value could be reallocated from the preferred stock to the common stock, creating additional OI for the employee. In contrast, in the partnership context, the fact that partners who provide capital are merely entitled to a return of their capital (but no yield) before SP shares in profits generally does not create an OI risk for SP. Because the partners providing capital are entitled to a return of their capital before SP is entitled to anything, SP's interest is still a profits interest with a zero liquidation value.")

Compensation for services is normally treated as ordinary income. Whether in the form of cash salary, a performance bonus, a trip to Bermuda or a Christmas ham – tax generally treats all such payments as ordinary income.<sup>125</sup> In the partnership context, deciding whether a distribution is compensation for services or is a share of partnership income is a difficult issue when the recipient, like the GP here, is a partner in the partnership. Section 83, enacted in 1969, addresses the receipt of property in exchange for services. It provides the general rule that property received in connection with the performance of services is income.<sup>126</sup> A simple reading of section 83, then, suggests that the GP should be taxed immediately on the option value of the carried interest, and because the carry is received in exchange for future services, the exchange would seem to give rise to ordinary income. Section 707 further addresses payments from a partnership to a partner. So long as the payment is made to the partner in its capacity as a partner (and not as an employee) and is determined by reference to the income of the partnership (i.e. is not guaranteed), then the payment will be respected as a payout of a distributable share of partnership income rather than salary. Arguably, the initial receipt of the carried interest is better characterized as itself a guaranteed payment (as it is made before the partnership shows any profit or loss).<sup>127</sup> However, Rev. Proc. 93-27 implicitly overrides this possible interpretation of sections 83 and 707.<sup>128</sup> For tax purposes, then, the initial receipt of a profits interest is not a taxable event, and subsequent distributions will be respected as payouts of the distributable share of income.

To determine the character of payments made pursuant to the carried interest, the tax law treats distributions of cash or securities under the terms of the carried interest as it would any other distributable share of income from a partnership. Because partnerships are pass-through entities, the character of the income is preserved as it is received by the partnership and distributed to the partners. Here, the distributable share of income is typically generated by the sale of stock in a portfolio company, which is normally capital gain. Capital gain is taxed at a lower rate than ordinary income.<sup>129</sup> Moreover, the venture fund’s investment in portfolio companies sometimes fit into the definition of “qualified small business stock,” reducing the tax rate even lower.<sup>130</sup>

The tax law thus carves a wide gap between the economics of the carried interest and its treatment for tax purposes. The receipt of carry is economically valuable at the outset and is received in exchange for services rendered. Under a pure economic concept

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<sup>125</sup> See IRC § 61.

<sup>126</sup> See IRC § 83(a).

<sup>127</sup> See Cunningham, 47 Tax. L. Rev. 247, 267 (“Because the value of a partnership interest received by a service partner, whether capital or profits, invariably is dependent upon the anticipated income of the partnership, the mere fact that the right to reversion of the capital has been stripped from the interest does not convert the property interest represented by the profits interest into a distributive share of partnership income. Even though the value of a profits interest or capital interest cannot be determined without reference to partnership income, the property interest itself has a fixed value, and its transfer is a payment of a fixed amount (that is, a guaranteed payment), rather than a mere distributive share of partnership income. Clearly, subsequent allocations of profits, either under the undivided capital interest or under the bare profits interest, are distributive shares not subject to § 707, although the one time transfer of the interest itself is.”)

<sup>128</sup> Cite to 707(a) and 707(c) and explain more.

<sup>129</sup> See § 1(h).

<sup>130</sup> See §§ 1202, 1045.

of income, the GP should pay tax upon receipt of the interest, take a basis in the carry, and recognize further income or loss as the partnership makes or loses money. Instead, the tax law allows the GP to defer tax by treating the initial receipt of carry as a nonevent for tax purposes, and then allows the GP to treat the receipt of distributions as capital gains rather than as ordinary income, notwithstanding the fact that the distributions are related to the GP's performance of services for the partnership.<sup>131</sup>

Sophisticated readers may note that I have left out a significant piece of the tax analysis: the treatment of the partnership (and thus the impact of these rules on the other partners). In general, treating the receipt of a profits interest by the GP as a nonevent for tax purposes is good for the GP but bad for the LPs, as the partnership may not take a deduction for the value of the interest paid to the GP, and the LPs lose the benefit of that deduction. If the GP and LPs have the same marginal rates, then the tax benefit to the GP of Rev. Proc. 93-27 would be perfectly offset by the tax detriment to the LPs. In fact, GPs not only typically have a higher marginal rate than LPs; a majority of LPs are tax-exempt and have a marginal rate of zero.

Rev. Proc. 93-27 is thus especially important in this context because the majority of LPs are not harmed by the loss of the tax deduction. Over 50% of investors in venture capital are tax-exempt pension funds, and other investors, such as private foundations, university endowments, and others are tax-exempt or have lower rates. Thus, by taking full advantage of 93-27, tax planners are not merely redistributing value between the GP and the LP, they are creating value for the parties by shifting value away from the public fisc. Subject only to the limitation of the distorting effect on contract design, it becomes rational for fund lawyers to take full advantage of the gap between the economics of the carried interest and its treatment for tax purposes.<sup>132</sup>

## **B. The Impact of Tax on Carried Interest Design**

The tax law thus provides a powerful incentive that affects the design of venture capital compensation. By drawing a sharp distinction between a capital interest in a partnership and a profits interest in a partnership, LPs should strive to pay GP with a profits interest so long as doing so does not unduly distort incentives. Further, to the extent that the carried interest is a substitute for other forms of compensation, LPs should strive to pay as much as possible in the form of carry and as little as possible in the form of cash salary.

Venture funds do exactly this. By starting the carry at nominal profits of zero, venture funds maximize the amount of compensation paid in the form of carried interest, which maximizes the amount of compensation deferred by the GP. If the fund employs a preferred return, starting the carry at a higher threshold, then the fund is not maximizing

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<sup>131</sup> It's less clear what happens with an in-the-money carried interest. Outside the safe harbor of 93-27, it's possible that a carried interest that was \$1 in the money would trigger immediate tax on the full amount. Levin argues, however, that "a far more rational reading is that the IRS intends that the taxpayer-favorable [liquidation value] rule not be available only *to the extent* the service provider's partnership interest is in the money at receipt[.]" Levin, *supra* note xx, at 10-17.

<sup>132</sup> Given that a structure that maximizes benefits for both the GPs and a majority of LPs is probably best for all; for this and other reasons taxable LPs gravitate away from venture capital, creating a clientele effect.

the amount of compensation paid in the most tax-efficient form. If, in response to the imposition of a preferred return, the GP demands a higher management fee, that management fee would be taxed upon receipt, and would be treated as ordinary income rather than as capital gains.<sup>133</sup>

The option analogy may again be useful. The tax law provides a strong incentive to pay partnership executives with an option-like instrument rather than a forward-like instrument. It also provides an incentive to establish the strike price of the option as low as possible without putting the option in the money (which in turn would give the option a current liquidation value and upset the tax treatment). By excluding a preferred return, the fund sets the strike price at the money. By keeping the strike price fixed rather than increasing it over time, it further maximizes the option value of the carried interest. Moving the strike price any higher would lead to other compensation paid in less tax-favorable form; moving the initial strike price any lower would create immediate tax liability to the GP.

To frame the problem in a slightly different way, consider the design of compensation from a tax point of view, ignoring incentive effects. To minimize taxes, the GP should receive as much compensation as possible in the form of capital gains, and should pay tax on that compensation as late as possible. A tax-efficient scheme, then, would consist entirely of a profits interest in the partnership, and no management fee whatsoever.

The real world makes this difficult, however, as investment professionals do need steady income to pay fund expenses, receive some salary to make mortgage payments, car payments, and to live in the manner in which they have become accustomed. In theory, GPs could borrow this amount from outside lenders using the carried interest as collateral, but information costs make such borrowings expensive.

The next best solution, then, is to keep management fees low and maximize the carried interest. In designing the carried interest, moreover, one would want to include both firm-specific and non-firm-specific risk, as VCs would have difficulty hedging away firm-specific risk. By excluding the preferred return and not indexing the carried interest, that is exactly what venture funds do. A preferred return would move the strike price of the option out of the money. Indexing the carry to an industry benchmark would amplify firm-specific risk, reducing the value of the carry. In the other direction, setting the strike price of the option in the money would give it a current liquidation value, thus upsetting the favorable tax treatment. Although perhaps not consciously, the market for GP compensation has found its way to the most tax-efficient result.

### **C. Turning the puzzle around**

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<sup>133</sup> Levin reports that some GPs opt to reduce their management fee in exchange for a higher profits interest, either up front (as I suggest here) or by reserving the right to periodically waive the fee in exchange for an enhanced profits interest. See Levin, *Structuring Venture Capital*, supra note xx, at 10-13. So long as there is some economic risk that further fund appreciation will not occur, periodic waivers will successfully convert OI into LTCG. See *id.*

The tax explanation for the absence of a preferred return in venture capital contracts helps solve one puzzle but creates another. If the tax incentive to pay compensation in the form of carried interest is so powerful, then why don't buyout funds and other private equity funds follow suit? Tax has turned our puzzle inside out: venture funds start the carry on a first dollar basis to pay as much compensation as possible in a tax-advantaged form. The new challenge is to figure out why buyout funds and other private equity funds include a preferred return. Why are preferred returns used at all? I focus on two reasons: reputation and investment strategy.

The first reason is simple: deal flow incentives may be more important in some funds. Even some VC funds use preferred returns, and it appears that preferred returns became more common in venture funds as the size of the market grew, presumably introducing more VCs of unknown reputation. Preferred returns may be more common in buyout funds in part because it is difficult to know or rely on the reputation of buyout managers than VCs. Buyout firms tend to be larger than VC firms, so perhaps investors can be less confident that the managers they know will end up directing their investments.

But the near uniformity of the preferred return in buyout suggests that there must be more. The second reason a preferred return is used is institutional: outside of the venture context, the preferred return also protects private equity investors against a moral hazard risk. Specifically, in the absence of a preferred return, the manager of a buyout fund might choose a low-risk, low-return strategy.

The strategy of many buyout funds is to take stodgy, underperforming companies and turn them into streamlined high-performance firms. Buyout funds might do this by replacing management, changing corporate strategy, or breaking the company up and selling it off in pieces. And so a company that generated an annual return to stockholders of 5% a year might be transformed into a company that generates, for the buyout fund, a return of 20% or more. The carried interest gives buyout fund managers a financial incentive to pursue this strategy by giving them a share of the upside.

Without a preferred return, however, the fund manager's incentives may be distorted. After all, if the fund invests in a company that returns 5% a year, the fund manager still enjoys 1% -- 20% of the 5% -- in the form of carried interest. The fund manager may choose to pursue a low-risk, low-return strategy either by changing very little about the company after the investment is made, or even by choosing companies that have very little potential to generate large returns, but might be safer investments.

Consider, simply for illustrative purposes, a hedge fund that starts with \$1 billion in capital and a ten-year life. Suppose the GP receives a straight carry under the terms of the partnership agreement, just as in a venture capital fund. A sensible strategy for the GP would be to take the \$1 billion in partnership capital and buy ten year Treasury notes, thus virtually guaranteeing a 6% return over the next ten years. Each year, the GP will receive 1.2% of the return (20% of the 6%), or \$12 million dollars, for doing virtually no work and costing itself nothing beyond its reputation and ability to raise future funds. In the hedge fund context, it's not likely that this simplistic approach would work. Investors

would observe the investment in Treasury Notes and withdraw their capital. And the hedge fund manager's reputation would suffer greatly.

In the buyout context, however, it may be more difficult for investors to observe what the fund managers are doing. While they will normally be able to find out the identity of each portfolio company and the broad plans for reorganization of the company, the difference between a stodgy company and a stodgy company with great potential is highly subjective. And, unlike in the hedge fund example, the investors' capital is locked in. Because fund managers could easily hide a low-risk, low-return strategy, include a preferred return is important to aligning incentives, notwithstanding the tax cost.

Reputational costs might constrain the fund manager's decision to take the easy way out, but the difference in investment decisions might be more subtle than in this stylized example, making it difficult and expensive for future investors to recognize the self-interested decision-making. A preferred return solves this moral hazard concern by rewarding the fund manager only for investments that include enough upside potential to clear the hurdle.

GPs can also lower the riskiness of the portfolio by choosing diverse portfolio companies, and investing smaller amounts in more deals, than investors would like.<sup>134</sup> A recent paper by Douglas Cumming and others documents the moral hazard risk, which they call "style drift."<sup>135</sup> While some style drift concerns may be addressed by contract, it is expensive for LPs to draft and to monitor compliance with these terms. GPs are in a better position than LPs to understand the portfolio company business plans. And so addressing this agency cost indirectly through a preferred return may be more efficient – notwithstanding the tax inefficiency – than using a straight carried interest and trying to monitor more closely what the GPs are doing.

For venture funds, the moral hazard risk of taking a low-risk strategy is smaller than in buyout funds, as venture fund managers rarely find investments that are safe and low risk. The terms of the limited partnership fund agreements typically require the fund managers to invest only in start-up companies or growth companies in certain carefully defined industries. Reputational constraints are stronger as well, as it is easy for investors to see the difference between a start-up and an established company, while it may be more difficult to distinguish a safe mature company from a riskier one.

In the end, these institutional differences between venture funds and buyout funds, along with the tax incentive to maximize equity-based compensation, explain the missing preferred return. It's difficult for buyout fund investors to monitor what buyout fund managers are investing in, and there's an unacceptable risk that absent a hurdle rate,

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<sup>134</sup> The moral hazard concern is present even when the choice is between two investments of roughly equivalent net present value. Institutional investors treat private equity as an "alternative asset class," meaning that it is valued in large part for its diversification effect. Using a preferred return ensures that private equity managers, given a choice, will never choose an investment with a likely return below 8%. The preferred return, in other words, protects the diversification effect of private equity.

<sup>135</sup> See Douglas Cumming et al., *Style Drift in Private Equity*, available on [ssrn.com](http://ssrn.com), May 30, 2004 version, at 4.

buyout fund managers will choose a low-risk, low-return strategy, at least on the margins. Venture is different. It's not that VCs are saints. But there's no such thing as a low-risk, low-return high tech start-up. And so taking full advantage of the tax treatment of a profits interest in a partnership makes sense.

## VI. Conclusion

Tax distorts the design of venture capital compensation by encouraging the use of risky, equity-linked compensation over management fees. Because the tax treatment is more favorable than the economic reality, the tax law can be viewed as subsidizing VCs. Because the market for investors is somewhat competitive, the subsidy is likely split between the VCs and their investors. And so it is more accurate to say that the tax law subsidizes venture capital investing, not just VCs. The normative implications are not obvious.

In general, a gap between the tax treatment of a transaction and its economic treatment is troubling from a policy perspective. Gaps create deadweight loss by distorting the behavior of participants. Here, VCs may be engaging in riskier strategies than their investors would prefer, rushing products to market and pushing management to pursue IPO exits. Notwithstanding this potential negative externality, the status quo may be acceptable from a policy perspective for two reasons. First, the solution may be worse than the problem. Changing the tax law would give rise to enormous uncertainty and administrative headaches for practitioners and the IRS alike. Second, a tax subsidy for venture capital may be a worthwhile expenditure of public resources. Although a full blown defense of subsidizing venture capital is beyond the scope of this article, a short explanation may be useful.

Pragmatism provides the first reason to keep the status quo. Current law may be the inevitable product of administrative concerns. The tax law fails to recognize and tax the option value of the carried interest because it would be extremely difficult to calculate. Unlike publicly traded options that can be valued using Black-Scholes or other models developed by economists, the value of the carried interest depends on the efforts of the GP. There is no option value except what the GP creates. Because LPs use the profits interest to motivate the GP, the GP cannot sell its profits interest. It's a vastly different situation than receiving marketable options on a publicly traded stock. And so agreeing on the value of a profits interest in a partnership is no easy task, and the administrative headaches would consume large amounts of IRS resources.

Moreover, fund advisors could react to a change in the tax law by replacing the carried interest with a financial equivalent: an option to acquire a capital interest in a partnership. An option to acquire a 20% capital interest in the partnership with a strike price set at 20% of the initial fund value is financially equivalent to and provides the same incentives as the usual 20% carry. Under current law, the issuance of an option to a service provider generally is not treated as a taxable property transfer under section 83,<sup>136</sup>

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<sup>136</sup> See section 83(e)(3); Treas. Reg. section 1.83-3(a)(2);

although what happens on exercise is less clear.<sup>137</sup> Changing the rules on the treatment of a profits interest in a partnership would just move the battleground to a different, financially equivalent arena.

Economic growth provides the second reason to keep the status quo. Subsidizing venture capital may be a good idea. Venture capital-backed start-ups create jobs. And unlike other small businesses like restaurants, dry cleaners or hotels, these start-ups create new technologies and fuel expanding market sectors. The whole point of venture capital is to grow small businesses into large ones, and when these businesses become large, the jobs they offer are of a higher quality, and may be less likely to be outsourced, than jobs created by large firms. While I recognize that much more needs to be said to justify a tax subsidy for venture capital, there is at least reason to think that a knee-jerk reaction to change the treatment of a profits interest in a partnership may not be wise.

Tax can have a powerful impact on contract design, even in an area like venture capital where deal structures are not thought to be tax-driven. Ron Gilson and David Schizer have argued that tax drives the basic deal structure at the portfolio company level, leading VC funds to use convertible preferred stock.<sup>138</sup> Like Gilson & Schizer, I believe delving into the tax plumbing of deals is a worthwhile endeavor. Here, I have argued that reputation and institutional differences between buyout funds and venture funds are the primary drivers of deal structure, but I have also argued that tax almost certainly changes decisions at the margins. Without tax, we could expect to see more variety in VC fund agreements: we would see both more preferred returns (for low reputation VCs) and also some “in-the-money” carried interests or even capital interests (for high reputation VCs).

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<sup>137</sup> See NYSBA Tax Section, *Taxation of Partnership Options and Convertible Securities*, Tax Notes, (March 4, 2002) 1179, 1201-03.

<sup>138</sup> See Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 875 (2003).