VENTURE CAPITAL FUNDS, ORGANIZATIONAL LAW, AND PASSIVE INVESTORS

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I. INTRODUCTION

The current orthodox view is that investors in U.S. venture capital funds are passive.1 They delegate decision-making authority and other management responsibilities to the fund manager.2 Legal scholarship on the U.S. venture capital market, however, has offered surprisingly little analysis on why venture capital fund investors are passive.3 Furthermore, scholars have almost

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+ Editor’s note: citations to foreign language sources are translated by the author.

1 In brief summary, the birth and life of a venture capital fund looks something like the following: A fund manager promotes the establishment of a venture capital fund. The fund manager only invests a small amount in the fund, and the vast majority of the fund’s capital comes from other investors. Once the fund is organized and begins operating, it invests in promising, young companies.

2 See, e.g., Michael Klausner & Kate Litvak, What Economists Have Taught Us About Venture Capital Contracting, in BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54, 54 (Michael J. Whincop ed., 2001) (“[The investors] delegate all investment and monitoring decisions to the VC; and they have no control and few monitoring rights over the VC’s actions.”); Ronald J. Gilson, Engineering a Venture Capital Market: Lessons from the American Experience, 55 STAN. L. REV. 1067, 1070 (2003) (“The typical transactional pattern in the U.S. venture capital market is for institutional investors . . . to invest through . . . ‘venture capital funds,’ in which the investors are passive limited partners.”); Paul Gompers & Josh Lerner, The Use of Covenants: An Empirical Analysis of Venture Partnership Agreements, 39 J.L. & ECON. 463, 469–70 (1996) (“[O]nce the funds have been raised, the [investors] have very limited recourse to these funds.”).

3 In fairness, existing scholarship has argued that the investor’s delegation of complete discretion to the fund manager is an efficient management strategy because the fund manager’s expertise reduces the uncertainty and information asymmetry characteristic of investment in early-stage, high-tech companies. See Klausner & Litvak, supra note 2, at 57; Gilson, supra note 2, at 1088. However, this argument makes implicit assumptions about the quality and nature of both the investors and the fund manager, which this Article discusses in more depth. See infra Parts II, V. In addition, the argument does not address why the fund manager must be given total discretion, as opposed to a significant amount of discretion, or none at all. In other words, why can the investors not benefit from the fund manager’s
completely ignored the possibility that investors could be active in their fund's business.\(^4\)

The emphasis that scholarship has placed on passive investors in venture capital funds might cause one to assume it was a global phenomenon. In fact, it is not. The Taiwanese venture capital market, for example, is dominated by funds whose investors are active in decision-making and other aspects of the fund's business.\(^5\)

This Article does not directly challenge the view that investors in most U.S. venture capital funds are passive,\(^6\) but it does question why a venture capital market in any jurisdiction would exhibit a preference for either active- or passive-investor funds. More specifically, this Article questions whether organizational law influences a venture capital market to develop a preference for either strategy. Indeed, when scholars have addressed the question of investor passivity in U.S. venture capital funds, they have tended to focus on how the preferred organizational form for U.S. venture capital expertise by making the fund manager an advisor, rather than the sole decision-maker? See infra Part II.B. Finally, the argument appears to assume that the parties will choose the limited partnership form, which has certain mandatory allocations of power between investors and managers. This assumption makes the argument sound more like a rationalization for the limited partnership form, rather than an argument that the management strategy is optimal. This Article recognizes the possibility that the parties will use other organizational forms besides the limited partnership and discusses how that will influence the choice of management strategy. See infra Part III.


\(^5\) See infra Part V.B.

\(^6\) I have my suspicions that there are indeed a significant number of active-investor funds in the U.S. venture capital market. Although the main characteristic of active-investor funds is investor participation in decision-making, there are other indicia of investor activity: investors may share their expertise or information with the fund’s management or assist in finding investment opportunities. In an article published in 1990, William Sahlman provided a tantalizing, albeit brief, glimpse into the existence of active-investor funds in the United States. He stated that “[a]dvisory boards and boards composed of [investors] are often designed to provide access to deals or technical expertise.” William A. Sahlman, The Structure and Governance of Venture-Capital Organizations, 27 J. Fin. Econ. 473, 493 (1990). But see Gilon, supra note 2, at 1088 (characterizing advisory committees as “largely inconsequential”). The main question that the statement from Professor Sahlman raises is not whether active-investor venture capital funds exist in the United States, but why they exist. Why would investors make these kinds of non-capital contributions to the fund? See infra Parts II.A, III.D.
capital funds, the limited partnership, contributes to investor passivity.\(^7\)

Against the backdrop of the U.S. experience, an initial glance at the Taiwanese venture capital market raises even more questions regarding the role of organizational law in creating a market preference for a specific management strategy. In Taiwan, where active-investor funds are prevalent, funds organize as corporations, not limited partnerships. The contrast between the Taiwanese and U.S. venture capital markets causes us to ask why passive-investor funds do not dominate in Taiwan as they do in the United States and whether organizational law has an influence on this difference.\(^8\)

Admittedly, there are strong arguments that organizational law should not influence a market preference for either management strategy. In most cases, a fund’s choice of management strategy—active or passive-investors—will determine the organizational form it chooses, not vice versa. That is to say, the limited partnership form will not influence a preference for passive-investor funds in a venture capital market. Instead, market conditions cause the participants in the market to prefer a passive-investor strategy and they then select the limited partnership because it suits their management strategy. Similarly, the corporate form does not influence a preference for active-investor funds in a venture capital market. Instead, participants in the market choose to pursue an active-investor strategy and then organize as corporations because the corporate form best meets the needs of their preferred management strategy.

These arguments have obvious merit, but they assume that organizational law in every jurisdiction creates sufficient choice and flexibility for the parties.\(^9\) When organizational law does not

\(^7\) The typical analysis has been that U.S. venture capital funds prefer to organize as limited partnerships for tax and liability concerns. In order to receive both limited liability and pass-through taxation, the investors in the fund become limited partners. The limited partners, however, must remain passive because the law does not give them any right to participate in the partnership’s business and will sanction them if they do in fact participate. See, e.g., Paul A. Gompers & Josh Lerner, The Venture Capital Cycle 29 (1999) (discussing the problems limited partners face if they become involved in management and the limitations that exist on selling interests); Klausner & Litvak, supra note 2, at 69; Gilson, supra note 2, at 1088; Sahlman, supra note 6, at 489–90.

\(^8\) The Taiwanese venture capital market is one of the world’s most important venture capital markets. See Christopher Gulinello, Engineering a Venture Capital Market and the Effects of Government Control on Private Ordering: Lessons from the Taiwan Experience, 37 Geo. Wash. Int’l L. Rev. 845, 848–49 & nn.16–17 (2005).

\(^9\) See Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84
provide choice and flexibility, however, then it will influence the decisions of the parties in the market to pursue either active- or passive-investor strategies and contribute to a market preference for a particular strategy. Thus, although there may be many factors that contribute to the predominance of passive-investor funds in the United States and active-investor funds in Taiwan, we should not unquestioningly accept the status quo as efficient. Rather, we should consider whether organizational law hinders more efficient contract design.

This Article analyzes whether organizational law has an influence on the development of a market preference for either active- or passive-investor venture capital funds. Indeed, organizational law will have such an influence, but only at the margin. Outside the margin, organizational law will not influence the creation of a preference, but it will often create additional transaction costs for the market. The practical implications are obvious for nations that may adjust their organizational laws to accommodate and promote burgeoning venture capital markets. Without an understanding of organizational law's influence on the venture capital market, legislative decisions to amend or retain current organizational laws may lead to suboptimal private ordering.

This Article also explores private ordering within active-investor venture capital funds. If passive investment in venture capital funds is not inevitable, as the Taiwanese experience indicates, then we are confronted with the question of how the parties in active-investor funds reduce their transaction costs. Because existing scholarship has focused almost exclusively on passive-investor venture capital funds, there has been no discussion of the transaction costs of active-investor funds. Do the transaction costs of active-investor funds differ from those of passive-investor funds? If they do differ, what strategies do the parties employ to reduce them? What benefits do the parties receive from an active-investor strategy that may offset these costs? This Article attempts to provide a foundation for analyzing the transaction-cost strategies of active-investor venture capital funds.

Part II of this Article discusses generally why parties choose either active- or passive-investor strategies. This Part explains the transaction costs of each strategy.

Part III examines how organizational law influences the parties’ choice between active- and passive-investor strategies, thereby contributing to a market preference for a particular strategy. It explores whether particular organizational forms, i.e., the limited partnership form and the corporate form, make it more difficult for parties to reduce the transaction costs or exploit the benefits of their preferred management strategy. Part III also discusses how the venture capital fund manager can reduce transaction costs specific to each of the active- and passive-investor strategies.

Part IV further analyzes passive-investor venture capital funds. It asks whether the limited partnership control rule contributes to the efficiency of the U.S. venture capital market by reducing the transaction costs of passive-investor funds.

Part V further analyzes active-investor venture capital funds by examining the Taiwanese venture capital market. This Part briefly discusses the factors, including organizational law, that may contribute to the popularity of the active-investor strategy in Taiwan. This Part, then, explores the strategies Taiwanese active-investor funds employ to reduce the transaction costs and maximize the net benefit of the active-investor fund.

II. THE COSTS AND BENEFITS OF THE ACTIVE- AND PASSIVE-INVESTOR STRATEGIES

When parties plan to pool their resources to establish a firm—whether it is a venture capital fund or some other type of firm—they will naturally need to decide whether the investors will be active or passive in the management of the firm’s business. 10 When the benefits of a particular management strategy, i.e., an active- or passive-investor strategy, outweigh its costs, then the parties will reap a net benefit under that strategy. Obviously, if one strategy provides a net benefit and another does not, then the parties will choose the strategy with the net benefit. When the parties are able to realize a net benefit with either an active- or passive-investor strategy, they will choose the strategy that provides the greater net benefit.

When three friends decide to start a company, for example, their

10 This is just one of many decisions they will make. See Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 2–3 (1991).
decision to act as the directors and the key management employees of the company may seem like an obvious choice, but there were other strategies available to them. Instead of running the firm themselves, they could have hired a management team and remained passive in the firm’s business. They decided to be active-investors because their net benefit under an active-investor strategy outweighed their net benefit under a passive-investor strategy.\textsuperscript{11}

Parties who form a venture capital fund will engage in the same deliberation regarding whether the investors will be active or passive. We might make assumptions, based on our preconceived notions of venture capital funds, that the investors will decide to delegate all responsibility to the fund manager and remain passive in the fund’s business decisions. This strategy may be very common in the U.S. venture capital market, but only because the participants in the market have determined that, under most circumstances, their net benefit under a passive-investor strategy will be greater than their net benefit under an active-investor strategy.

There are various market factors that will influence a preference for active- or passive-investor funds in a particular venture capital market. For example, the market may have many institutional investors whose large, diversified investment portfolios make it impractical for them to participate in their funds. In contrast, a market may be dominated by corporate investors with expertise and industry connections that make them better candidates for active-investor funds than institutional investors would be.

In addition, the number of qualified fund managers in the market may influence the number of active- or passive-investor funds. If there are fewer qualified managers, then there may be more funds with active investors whose expertise and industry connections supplement the performance of less qualified fund managers. Conversely, a greater number of qualified fund managers in the market may result in more passive-investor funds.\textsuperscript{12}

One could also imagine that the presence of entrepreneurs who

\textsuperscript{11} See Charles R. O’Kelley, Jr., Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis, 87 NW. U. L. REV. 216, 220 (1992) (“[I]f rational individuals choose to become shareholder-employees of a closely held corporation, they do so in the rational belief that such choice will maximize the value of their human and money capital.”).

\textsuperscript{12} An efficient market for reputation will probably contribute to an increase in the number of qualified fund managers because it gives fund managers incentives to invest in their competence. See infra Part IV.C.
want to protect their information and technology would negatively affect the creation of active-investor venture capital funds. If a fund’s investors are active in the fund’s business, then more people will have access to the confidential information of its portfolio companies. Thus, when the nature of an entrepreneur’s information or technology requires confidentiality, she would prefer to accept investment from a passive-investor fund.

Regulatory factors will also play a role in the establishment of active- and passive-investor funds. For example, securities laws that limit public offerings, and thus make it difficult to realize a diffuse-ownership structure, may make the active-investor strategy more prevalent. On the other hand, securities laws that effectively force funds to solicit capital almost exclusively from institutional investors may influence the creation of more passive-investor funds.

In addition to market and regulatory factors, organizational law will also have an influence on a market preference for a particular strategy when it influences the decisions of the participants in the market between active- and passive-investor funds. Organizational law’s influence on these decisions depends on whether its organizational form(s) allow(s) the parties to minimize the transaction costs and maximize the benefits that are inherent to their preferred management strategy. This Part introduces the costs and benefits of the active-investor strategy (Part II.A) and the costs and benefits of a passive-investor strategy (Part II.B).

A. The Costs and Benefits of an Active-Investor Strategy

William Sahlman reported that there were U.S. venture capital funds with investor boards that were designed to provide the fund with “access to deals or technical expertise.” This raises a simple question—why would an investor sitting on an advisory board like this provide the fund with any assistance? When an investor actively participates in the firm’s business, she bears the costs of the other investors who free-ride on her efforts. The active investor would prefer to adopt some sort of strategy to eliminate or reduce

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13 See generally Larry E. Ribstein, The Important Role of Non-Organization Law, 40 WAKE FOREST L. REV. 751, 753 (2005) (contending that non-organizational law will have a more significant influence on the structure of firms than organizational law).
14 See id. at 754 (“[R]ules that firms cannot easily select by contract or by choosing their state of organization can determine the shape of business associations.”).
15 Sahlman, supra note 6, at 493.
the free-rider problem.

The parties can address the free-rider problem by eliminating passive investors, compensating the active investor in some way, or adopting a strategy of mutual contribution from the investors. When eliminating the passive investors and compensating the active investors are not practical solutions, the parties will use a mutual contribution strategy, or “team production,”¹⁶ to reduce the free-rider problem.

We often focus on the problems of team production, but we must remember that team production is actually a solution for a firm. In order to operate its business, a firm needs various inputs, i.e., capital, manpower, ideas, skills, expertise, technology, and so on. It may be able to obtain these inputs through market transactions, but there may be certain advantages to obtaining these inputs through a team.¹⁷ Investors provide the capital inputs, of course, but a firm must have inputs in addition to capital for it to operate. These non-capital inputs may come from the investors or from other team members, such as employee-agents.

Where parties establish a closely-held firm and they expect all the investors to work for the firm full-time, they are solving two problems: they are obtaining the necessary capital and non-capital inputs from the investors¹⁸ and, in principle, they are eliminating free-riders—each investor will make non-capital contributions so there are no free-riders.¹⁹ For example, imagine that Bob, Mary, and Alice plan to start and invest in a firm. Bob brings management expertise, Mary brings financial expertise, and Alice brings technical know-how. If each of these investors intends to dedicate herself full-time to the firm, the parties have used team

¹⁶ “Team production . . . is production in which 1) several types of resources are used and 2) the product is not a sum of separable outputs of each cooperating resource.” Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV. 777, 779 (1972).

¹⁷ One of the questions asked in theory-of-the-firm scholarship is whether the parties can arrange these inputs more efficiently across markets or within firms. See R. H. Coase, The Nature of the Firm, 4 ECONOMICA 386, 390–91 (1937). For the purposes of this discussion, I am assuming that it is more efficient for the parties to arrange them within a firm.

¹⁸ This strategy may be more economical for many startup firms. See Henry Hansmann, Ownership of the Firm, 4 J.L. ECON. & ORG. 267, 272 (1988) (“Ownership commonly is assigned to persons who have some other transactional relationship with the firm. . . . [T]he ownership relationship can be used to mitigate some of the costs that would otherwise attend these transactional relationships if they were managed through simple market contracting.”).

¹⁹ They could have also chosen to eliminate the free-riding by eliminating the nonworking investor(s) or by compensating the working investor(s).
production to acquire both capital and non-capital inputs for the firm. They have also solved the free-rider problem if the value of each of their inputs is equivalent and they each enjoy the same rights to share in distributions and the residual claim.20

Of course, every business strategy has its costs, and team production is no exception. First, there are transaction costs associated with putting a team together: the parties must invest in finding team members with complementary inputs. Second, there are transaction costs associated with monitoring the productivity of each of the team members.

Team production will attain its highest efficiency only when the reward for team members correlates with their productivity.21 Because it is difficult to measure what portion of the output is attributable to each member, it is difficult to measure a team member’s productivity from observing the team’s output.22 Thus, it is difficult to reward the team members ex post based on the actual total production of the team. For example, imagine in the case of Bob, Mary, and Alice that their firm made a profit of $150,000. It is not clear how much of the profit was attributable to Bob’s management efforts, to Mary’s financial expertise, or to Alice’s technology.

Without a specific agreement between Bob, Mary, and Alice, the team’s profits would be distributed equally or in proportion to their investments, depending on the organizational form they have chosen.23 It is, however, very possible that neither method of distribution will accurately correlate with the team members’

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20 When we see full-time active investors receiving compensation for their work in the team-production context, there are three possible explanations: (1) the value of each of their non-capital plus capital inputs is not equivalent (this could mean a disparity in capital invested, in time devoted to the firm’s business, and/or in the value of the investors’ expertise); (2) their rights to distributions and their residual claims are not the same; (3) they want some protection against freeze-outs; and/or (4) they gain some tax advantage by compensating investors through salaries.

21 See Alchian & Demsetz, supra note 16, at 778 (“If rewards were random, and without regard to productive effort, no incentive to productive effort would be provided by the organization.”).

22 Id. at 779 (“[I]ndividual cooperating inputs do not yield identifiable, separate products which can be summed to measure the total output.”); Margaret M. Blair & Lynn A. Stout, Team Production in Business Organizations: An Introduction, 24 J. CORP. L. 743, 745 (1999) (asking “how should [the team members] divide the profits among themselves” when “[e]ach has made an essential contribution” and “[n]one can recover the full value of that contribution outside the team”).

23 In a partnership, the default rule would be equal distribution. In a corporation, the default rule would be distribution in proportion to shareholdings.
respective productive efforts. In order to better correlate production with activity, the parties might agree *ex ante* to some sort of distribution of profits based on how much they value each person’s expected contributions.\(^{24}\) Unfortunately, any *ex ante* agreement on the distribution of profits, whether it is a default legal rule or a contractual provision, will create perverse incentives for the parties.\(^{25}\) Each would have incentives to shirk because she would reap all the benefits of her shirking, but would only suffer part of its costs.\(^{26}\) Obviously, when each of the team members has an incentive to shirk, the firm’s productivity will suffer.

To police against shirking, the parties must engage in monitoring. However, because the parties cannot effectively monitor for shirking by observing the team’s output,\(^{27}\) they must monitor by observing each team member’s input. Thus, the actual transaction costs of team production are the expenses the parties must incur in monitoring each other’s input behavior.\(^{28}\)

Our hypothetical with Bob, Mary, and Alice lies at the far end of the spectrum of investor activity,\(^{29}\) i.e., where the investors are active full-time in the firm’s business. Somewhere further down on the spectrum, possibly lying closer to the passive-investor side, lies the firm where investors delegate many of the management responsibilities to a specialized manager, but still participate in the firm’s business decisions and make other non-capital contributions to the firm.\(^{30}\) In this type of active-investor firm, the investors

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\(^{24}\) However, it will be an imperfect attempt because of information costs and bonded rationality. The problem of defining and setting compensation is what Alchian and Demsetz refer to as "metering productivity and rewards." Alchian & Demsetz, supra note 16, at 778.

\(^{25}\) See John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 837–38 (1999) (“Team production models generally predict that the ‘team’ will produce more surplus if control over that surplus is neither specified ex ante, nor left wholly unspecified for ex post resolution, but is left in some party’s discretion.”).

\(^{26}\) Alchian & Demsetz, supra note 16, at 780 (“If detecting [the behavior of individual inputs] were costless, neither party would have an incentive to shirk because neither could impose the cost of his shirking on the other . . . .”); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 Va. L. Rev. 247, 266 (1999) (contending that any agreement in advance to allocate profits creates shirking problems).

\(^{27}\) Alchian & Demsetz, supra note 16, at 781 (“[T]he detection of shirking by observing team output is costly for team production.”).

\(^{28}\) See id. at 780 (“Clues to each input’s productivity can be secured by observing behavior of individual inputs.”).

\(^{29}\) You could also conceptualize it as a spectrum of investor passivity.

\(^{30}\) Scholarship tends to discuss the issues of separation of the ownership and control and the unity of ownership and control by using as examples the large public corporation where the investors are completely passive in management and the closely-held firm where the
participate in business decisions; provide the management team with consultation, advice, information; and/or leverage their business connections for the benefit of the firm.

There may be times in this type of active-investor firm where the parties define what they expect of an investor in the way of non-capital contributions. More often, however, the parties will not have the foresight to be able to create an adequately specific contract and the investors will not want to be constrained by contractual provisions that are too explicit. In other words, the parties expect investors to make contributions to the firm’s business, but expect a more flexible, ad hoc approach to management.

Under these circumstances, why would any investor make the non-capital contributions described above? The investor may be willing to bear minimal costs of the free-rider problem by making some small, less significant contributions to the firm. However, to encourage investors to make more significant contributions to the firm and thereby maximize the benefit of this type of active-investor strategy, the parties will need to address the free-rider problem.

Because the ad hoc nature of the investors’ expected contribution makes compensating the investors an impractical solution to the free-rider problem, the parties will often select a team production strategy to address the free-riding problem. In other words, each investor, or most of them, will be expected to make non-capital contributions to the firm. Of course, as mentioned above, the parties will incur the transaction costs of team production: they will incur costs in finding investors whose non-capital contributions complement each other and the costs of monitoring each other against shirking.

The parties may be willing to bear the transaction costs of an active-investor strategy if they are outweighed by its benefits. The firm stands to receive great benefits from the non-capital contributions of knowledgeable or powerful investors. In order to maximize the net benefit under an active-investor strategy, the fund

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investors participate in the management on a full-time basis. However, we must remember there are intermediate categories. See, e.g., WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 109 (8th ed. 2002) (focusing on one of those intermediate categories).

31 Because contributing investors will bear the costs of the free-riding of any non-contributing investors, the parties have reduced the costs of the free-riding, but have not eliminated them when only a portion of the investors do not contribute.

32 See infra Part III.D (discussing how the parties may organize their monitoring efforts).
will need to assemble a group of qualified investors with complementary inputs, maximize their contributions to the firm, and reduce the costs of monitoring against shirking. However, the parties will only adopt an active-investor strategy if the net benefit under an active-investor strategy outweighs the net benefit under a passive-investor strategy.

B. The Costs and Benefits of a Passive-Investor Strategy

When the parties decide that the investors in their venture capital fund will remain passive and the fund manager will be entrusted with operating the fund, the parties bear the agency costs that are characteristic of this type of arrangement. When ownership is separated from control like this, there is a risk that the persons in control will engage in opportunism—that is to say, they will abuse their power and benefit themselves at the expense of the investors. This risk requires the parties to bear the costs of monitoring, bonding, and residual losses, i.e., agency costs. In more concrete terms, the investors will first incur costs in performing an ex ante evaluation of the fund manager’s honesty and then later incur costs in monitoring the fund manager’s conduct during the operation of the firm.

In addition to these agency costs, there are other transaction costs associated with the passive-investor strategy that have not often been discussed in academic literature—namely, the transaction costs created by the risk that investors will participate in the firm’s decision-making.

When parties select a passive-investor strategy for their venture capital fund, they have made the knowledge, experience, and even the identity of the investors irrelevant. This strategy provides a real benefit to the fund because it can significantly reduce capital costs. However, when the knowledge or experience of the investors is irrelevant, their participation in decision-making becomes a liability. As Professors Klein and Coffee have stated:

Each [investor] may actually find comfort in the fact that decisions relating to the management of the business will not be in the hands of people as inexperienced as himself or

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34 The fund manager will also incur the costs of signaling her honesty to the investors.
himself [sic]. This observation suggests that in some instances the owners of an enterprise may wish to deny control to themselves in order to ensure that others like them will not have it.35

The investors may not be alone in their desire to prevent themselves from participating in control of the fund. The fund manager may also be interested in investor passivity. She may want to prevent investors from interfering in her decisions, especially when she receives incentive-based compensation. Thus, the parties in a passive-investor venture capital fund will need to efficiently address the risk of investor participation in the firm’s decision-making in order to minimize the costs of the passive-investor strategy.36

There are benefits for the parties under a passive-investor strategy. With a passive-investor strategy, the fund reduces its capital costs because it is not limited to seeking capital from investors with any particular expertise, as would be the case for the active-investor fund. In addition, because the investors will be passive, they need not make the large investments that would make their participation more cost effective. This allows the investors to diversify their investments and reduce the overall risk of their investment portfolio. These benefits are very attractive, but the parties will only select a passive-investor strategy when the benefits outweigh the agency costs and the costs of preventing investors from participating in control.

C. Conclusion

When establishing a venture capital fund, the parties will choose either an active or passive-investor strategy depending on which strategy allows them to maximize their net benefit. In order to maximize their net benefit under a passive-investor strategy, the parties will need to address the agency costs associated with the

35 KLEIN & COFFEE, JR., supra note 30, at 103. Professor Margaret Blair has argued that the separation of ownership and control in the corporation is a benefit because it ensures that investors do not control decision-making, though she emphasized protection of employees and not the investors. Margaret M. Blair, Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century, 51 UCLA L. REV. 387, 433–34 (2003).

36 Essentially, the parties reduce their evaluation and monitoring costs with respect to the decision-maker. When they deny participation to the investors, they reduce the number of potential decision-makers. This reduces costs by limiting monitoring and evaluation to one decision-maker.
risk that the decision-maker will engage in opportunism and the monitoring costs associated with the risk that the investors will participate in the firm’s business decisions. The better the parties are able to address these costs, the more likely they will receive a net benefit under a passive-investor strategy.

In contrast, in order to maximize their net benefit under an active-investor strategy, the parties will develop methods to reduce free-riding by adopting a team production strategy. In active-investor funds where the investors delegate many responsibilities to a manager, but still make non-capital contributions to the firm, the transaction costs of team production are the costs of finding investors with complementary non-capital inputs and the costs of monitoring against shirking. To maximize their net benefit under an active-investor strategy, the parties will need to adopt strategies to maximize the non-capital contributions the investors make to the firm and minimize the costs of team production.

III. ORGANIZATIONAL LAW’S INFLUENCE ON A MARKET PREFERENCE FOR ACTIVE- OR PASSIVE-INVESTOR VENTURE CAPITAL FUNDS

The parties’ choice between an active- or passive-investor management strategy ultimately depends on which strategy allows them to maximize their net benefit. If a particular organizational form makes it difficult for the parties to reduce the transaction costs or exploit the benefits of their preferred management strategy, then the parties will select a different organizational form. If the jurisdiction’s law does not provide more than the one organizational form, then the parties will be forced to operate at a suboptimal level.

37 See O’Kelley, supra note 11, at 241 (“If internal governance needs were the sole basis for choosing organizational form . . . then [a particular organizational form] would come into existence only when [it] provided . . . a better balance . . . for a particular [ownership structure] than would be provided by alternative organizational forms.”). Another way organizational law may affect the costs of team-production in closely-held firms is with respect to default fiduciary duties. Professor Eric Talley has argued that enhanced fiduciary duties in closely-held businesses may undermine the efficiency of team-production because it gives investors incentives to increase their monitoring activities, which will reduce the time they spend in productive activities. Eric Talley, Taking the “I” Out of “Team”: Intra-Firm Monitoring and the Content of Fiduciary Duties, 24 J. CORP. L. 1001, 1003 (1999).

38 If the jurisdiction’s law provides an alternative organizational form that allows the parties to easily reduce the transaction costs and/or exploit the benefits of their preferred management strategy, then the parties will still operate at a suboptimal level if the alternative organizational form creates other transaction costs, i.e., tax disadvantages, limits on the number of investors, and higher filing fees.
Of course, in the real world, organizational law will not be the only factor that affects the parties’ decision. The parties may indeed be willing to bear the costs of a suboptimal management strategy under a particular organizational form if those costs are outweighed by regulatory and market benefits. These regulatory and market factors will vary from jurisdiction to jurisdiction. However, if we assume that market and regulatory variables are constant across jurisdictions, then we can isolate organizational law and study its influence on the parties’ choice between active- and passive-investor strategies.

As a crude example, let us assume the jurisdiction in which the parties organize their firm only provides one choice of organizational form—either the corporation or the limited partnership, but not both. Let us further assume that the organizational form available to them makes it comparatively more difficult for them to either minimize the costs or maximize the benefits of a particular management strategy. Under those circumstances, the parties in that jurisdiction will choose the alternative management strategy more often than parties in another jurisdiction.

In this Part, I argue that the limited partnership form is better suited for the passive-investor strategy than the corporate form because the limited partnership allows the parties to reduce the transaction costs of investor passivity more efficiently (Part III.A). I then argue that the corporate form is better suited for the active-investor strategy than the limited partnership because the corporate form allows the parties to reduce the costs of active investors more efficiently (Part III.B). Then, I explain when organizational law will influence the development of a market preference for a particular management strategy and when it will simply force funds to bear the transaction costs of their preferred management strategy (Part III.C). Finally, this Part discusses the role the venture capital fund manager can play in reducing the transaction costs in each of the active- and passive-investor strategies, regardless of organizational form (Part III.D).

39 See supra Part II.
A. Maximizing the Net Benefit of a Passive-Investor Strategy—The Limited Partnership Versus the Corporation

Imagine that a professional fund manager is planning to establish a venture capital fund. The plan calls for the fund manager to act as the sole decision-maker and for the investors to be passive in the fund’s business. For the parties to maximize the net benefit of this passive-investor strategy, the organizational form must allow them to structure their relationship to minimize the transaction costs associated with investor passivity.\(^{40}\) As presented in Part II.B, the costs of the passive-investor fund are the agency costs created by the risk of fund manager opportunism and the transaction costs created by the risk that investors will control the firm’s business decisions.

Since there is already a significant body of economic and legal scholarship addressing how parties structure their relationship to reduce the agency costs created by the risk of opportunism within both the corporate form and the limited partnership form,\(^{41}\) there is no need for this Article to provide a repetitive analysis on the subject. Suffice it to say that there is apparently no conclusion as to whether the limited partnership form or the corporate form allows parties to address these agency costs more efficiently. Thus, we can assume that neither organizational form holds any significant advantage.

However, the limited partnership form does have an advantage over the corporate form with respect to allowing the parties to efficiently reduce the transaction costs that are created by the risk that the investors will control decision-making.\(^ {42}\) If an organizational form creates channels through which investors can participate in decision-making, then it will be more difficult for the

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\(^{40}\) I am willing to concede that neither the corporate form nor the limited partnership form enjoys any particular advantage over the other in enabling the parties to exploit the benefits of a passive-investor strategy. The parties will enjoy the reduced capital costs of a passive-investor strategy whether they organize as a corporation or a limited partnership. Thus, this Part discusses the limited partnership’s advantages of reducing the transaction costs of a passive-investor strategy.

\(^{41}\) The literature relevant to venture capital limited partnerships is particularly interesting. Generally, the limited partners protect themselves from fund manager opportunism through a combination of contractual provisions and the market for reputation. See, e.g., Gilson, supra note 2, at 1087–90; Sahlman, supra note 6, at 493–94.

\(^{42}\) See supra Part II.B. We must also remember that the fund manager promoting a passive-investor fund will also seek to prevent investors from participating in control of the fund’s business.
parties to reduce the risk of investor control. If, on the other hand, the organizational form precludes the investors from sharing decision-making power with the fund manager, then it will be easier for the parties to minimize the costs of a passive-investor strategy.

One must keep in mind that even if an organizational form allows the parties to contractually preclude investor participation, it will not significantly reduce transaction costs unless there is a cost-effective enforcement mechanism that does not require constant monitoring by the investors. Thus, an organizational form will allow the parties to efficiently minimize the costs of a passive-investor strategy if (1) it enables the parties to easily create a contractual regime that prohibits investor participation and (2) it provides a low-cost way for the parties to enforce investor passivity.

Let us assume that the limited partnership in our hypothetical jurisdiction has attributes similar to what is common under U.S. state law. Therefore, the law provides that a limited partnership will have one or more general partners and one or more limited partners. It also creates certain mandatory rules with respect to liability of the partners and the delineation of decision-making power within the firm: (1) the law vests the general partner with the power to make the firm’s business decisions; (2) the law does not give the limited partners any right to participate in the management of the firm’s business; and (3) the general partner bears personal liability for the firm’s obligations, but the limited partners only bear limited liability.

This sort of limited partnership law makes it rather easy for the parties to use their limited partnership agreement to prohibit investor participation by simply designating the investors as limited partners and the fund manager as the general partner. However, this contractual arrangement does little to reduce monitoring costs for the investors, without an efficient mechanism to enforce it.

Fortunately, the limited partnership form also creates an efficient mechanism for enforcing investor passivity. The law places the management of the firm’s business in the general partner’s control. When the general partner has the proper incentives, her interests will converge with the investors’ interests in enforcing investor passivity and she will resist the attempts of any investor to encroach upon her exclusive right of control.\footnote{When she receives incentive-based compensation and is invested in her competence, she will have the proper incentives to enforce investor passivity. See infra Part IV.B. These are}
With that simple arrangement, the investors in the limited partnership have prohibited themselves from participating in the management of the firm’s business, have allocated the control rights to the general partner, and have put in place an efficient enforcement mechanism to police against investor control.\(^{44}\) In contrast, the parties in a firm that is organized as a corporation will not find it as easy to prohibit investor participation and enforce investor passivity.

In the traditional corporation, the board of directors manages the business and affairs of the firm. This may seem no different from the limited partnership in the sense that both organizational forms provide for centralized management—the limited partnership centralizes management in the general partner and the corporation centralizes management in the board of directors.

But there is a significant difference between the centralized management of the limited partnership and the centralized management of the corporation. The board of directors in the corporation provides a means for investor participation in the management of the firm. By electing themselves to the board, the investors in a close corporation not only control the board, they are the board.\(^{45}\) Consequently, the investors are the ultimate decision-makers in the close corporation.\(^{46}\) To reduce the costs of the passive-investor strategy, the parties will want to change the corporate form’s default allocation of power to the investors by either taking power away from the board or taking the board away from the investors.

More traditional corporate law regimes will either forbid arrangements that take decision-making power away from the board of directors, or look upon them with great suspicion.\(^ {47}\)}
while the parties may be able to take the board away from the investors with creative vote pooling and shareholder agreements, they may not be able to create cost-efficient enforcement mechanisms similar to those of the limited partnership.48

Because parties will find it significantly more difficult to prohibit investor participation and enforce investor passivity in jurisdictions with traditional corporate law regimes, they will find it more difficult to minimize the transaction costs of a passive-investor regime.49 When organizational law makes it significantly more difficult for the parties to minimize the transaction costs of a passive-investor strategy, they will either bear the costs of the passive-investor strategy or change to an active-investor strategy.

More progressive corporate law regimes, on the other hand, may provide the parties with sufficient flexibility to vary from the traditional role of the board of directors.50 Through the creative use of dual class share structures, shareholder agreements, vote pooling agreements, irrevocable proxies, voting trusts, and/or close corporation statutes, it may be possible to mimic the limited partnership’s prohibition on investor participation and create an enforcement mechanism of similar effectiveness. Even so, because of the increased administrative costs and potential legal uncertainty of some contractual arrangements, the parties may not be able to reduce the transaction costs of a passive-investor strategy as efficiently as parties in a limited partnership regime.51

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48 See supra note 43–44 and accompanying text.

49 The parties could also create a dispersed-shareholder firm where each investor only owns a very small percentage of the firm, thus allowing management to control the board. An initial public offering (IPO) of a venture capital fund’s portfolio company creates this type of firm. Effectively, an IPO transforms a portfolio company from an active-investor firm into a passive-investor firm with management, i.e., the entrepreneur, in control. See Bernard S. Black & Ronald J. Gilson, Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, 47 J. FIN. ECON. 243, 260–61 (1998).

50 See O’Kelley, supra note 11, at 242 (“Corporation statutes in all [U.S.] states now allow shareholders substantial freedom to modify the corporate adaptive rules by unanimous contractual agreement.”).

51 See id. at 247 (commenting that although it may be possible to contract for the “perfect” governance structure within the corporate form, the parties might not do so because “the costs of contracting might exceed the predicted benefits”); see also Black, supra note 9, at 562–63 (conceding that some corporate rules may not be trivial).
B. Maximizing the Net Benefit of an Active-Investor Strategy—The Limited Partnership Versus the Corporation

Now let us imagine that our fund manager is planning to establish a venture capital fund where the investors will be active in decision-making. To maximize the net benefit of this type of fund, the organizational form must allow the parties to structure their relationship to minimize the transaction costs of the active-investor strategy. This essentially means that it must allow the parties to maximize the non-capital inputs of the investors. When organizational law does not allow the parties to maximize the non-capital contributions of the investors, an active-investor strategy will be less desirable for the parties.

When investors participate in the fund’s decision-making, the fund will benefit from their knowledge and experience. To fully benefit from investor participation, however, the parties will first want to adopt strategies that encourage the investors to invest in the time and research that good decision-making requires, i.e., to invest in the deliberative process. Second, the parties will also want the investors to make other non-capital contributions to the fund, such as sharing valuable information on markets, products, or technologies and providing the fund’s portfolio companies with connections to lenders, underwriters, trading partners, and others. The parties can further both of these goals by allowing the investors to participate in control.

When an investor participates in control, her opinions will be given greater weight than if she simply held an advisory position. Her right to vote on business decisions provides her with some assurance that her opinions will be incorporated into the fund’s business decisions. This assurance gives her a greater incentive to invest in the deliberative process.

In addition, participation in control also gives her a greater incentive to make other non-capital contributions to the firm.

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52 See supra Part II.A. I am willing to concede that neither the corporate form nor the limited partnership enjoys any particular advantage in reducing the transaction costs of finding qualified investors. Thus, this Part discusses the corporate form’s advantage in reducing the free-riding and shirking of investors, i.e., maximizing the non-capital inputs of investors.

53 See Talley, supra note 37, at 1012 (“Encouraging high effort by the team members is important because it enhances the likelihood the project succeeds . . .”).

54 This assumes that the investors are knowledgeable and experienced.
an investor leverages her non-capital assets for the benefit of the firm, she is undertaking more risk than a passive investor who only risks her capital investment. She will be less likely to do so unless she has some control over the firm’s business. Hence, when the investor participates in control, she will be more willing to leverage her non-capital assets for the benefit of the firm. This allows the parties to maximize the net benefit of the active-investor strategy.

Because investor participation in control is essentially the default rule in the corporate form, the corporation is especially conducive to active-investor funds. By allowing the parties to give the investor a seat on the board, the corporate form institutionalizes investor participation in control without requiring full-time participation.

In a limited partnership, on the other hand, it is more difficult to give investors the same level of control they would receive in the corporation. Because limited partnership law vests the general partner, i.e., the fund manager, with all rights to control and gives the limited partners, i.e., the investors, none of these rights, investor passivity in the limited partnership is presumed. To receive the full benefit of the investors’ collective knowledge and experience by allowing them to participate in decision-making, the parties could make the investors general partners instead of limited partners. However, the investors might not be willing to bear a general partner’s risk of personal liability.

Alternatively, we could imagine that the limited partnership might attempt to simulate the corporation’s board of directors by establishing a board made up of limited partners. If this board had the power to approve or reject the general partner’s proposals, then it would provide investors with the same participation in control they would have enjoyed in a corporation. Under more traditional limited partnership regimes, however, there is a high probability that an investor’s participation of this kind would violate the “control rule” and subject her to loss of her limited liability.

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55 See KLEIN & COFFEE, supra note 30, at 47 (discussing how providers of non-capital input bear risk and thus may insist on control). “In the business world, who bears the risks calls the shots.” Id. at 45.

56 See supra notes 45–46 and accompanying text.

57 However, the consequences of personal liability in venture capital funds may be minor. Sahlman, supra note 6, at 490.

58 See Gilson, supra note 2, at 1088 (“The legal rules governing limited partnerships prevent investors from exercising control over the central elements of the venture capital fund’s business” and that “[m]ost importantly, the investors are prohibited from insisting on an approval right of the GP’s investment decisions.”).
To avoid running afoul of the control rule, the parties could form an investor advisory board. Limited partners participating in the advisory board would likely not violate the control rule as long as they had no power to approve or reject business decisions. However, although an advisory board would provide a vehicle for investor input, it would hinder the parties from fully exploiting the benefits of an active-investor strategy for two reasons. First, the general partner could ignore the advice of the investors and, thereby, disregard the valuable knowledge and experience the investors bring to the undertaking. It also means the investors would have less incentive to fully invest in the deliberative process that would make their advice most beneficial. Second, when the investors do not share in actual control of the fund’s decision-making power, they would be less willing to leverage their non-capital assets for the benefit of the fund. Thus, a more traditional limited partnership regime will prevent investors from institutionalizing and creating formal mechanisms for investor participation in decision-making, which will either discourage them from choosing an active-investor strategy or cause them to bear the costs of suboptimal investor participation.

More progressive limited partnership laws, on the other hand, have significantly watered down the control rule and thus diminished the risk that participation by limited partners would result in personal liability. For example, the 1985 version of the Revised Uniform Limited Partnership Act (RULPA) will not subject a limited partner to personal liability unless she has participated in control of the business and the claimant reasonably believed her to be a general partner. This type of generous control rule clearly allows investors who sit on a board with approval rights enough flexibility to protect themselves against the risk of personal liability. However, because it does not completely obviate the risk, even a progressive limited partnership law would still have some negative effect on the organization of active-investor firms.

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59 See infra Part IV (discussing the control rule).
60 For a more detailed discussion, see infra Part IV.A.
61 REVISED UNIF. LTD. P’SHP ACT § 303(a) (1976) (amended 1985) [hereinafter RULPA 1985]. It should be noted that the 2001 revisions to the RULPA completely abolished the control rule, which means that the investors with approval rights would be at no risk of violating the control rule. See infra note 106 and accompanying text. However, for a discussion of the possibility that an investor might still be liable as a general partner or under an estoppel theory, see infra note 118.
62 Fiduciary duties will also play a role in investor participation. If an investor will be
C. The Influence of Organization Law on a Market Preference

Imagine a spectrum of transactions where the parties' choices between active- and passive-investor strategies are based on market factors. Transactions at one end of the spectrum will lead the parties to select a passive-investor strategy, while transactions at the other end of the spectrum will lead the parties to select an active-investor strategy.

If organizational law does not allow the parties to efficiently address the transaction costs of their preferred strategy, then the parties will choose among three suboptimal alternatives:

(1) Their first alternative is to bear the costs of the preferred strategy. When market and regulatory factors cause the benefits of the preferred management strategy to exceed the organizational-law costs of the preferred strategy, the parties may choose to keep their preferred strategy.

(2) Their second alternative is to change to the less-preferred strategy. When the costs of organizational law are so high that they exceed the benefits of the preferred management strategy, the parties will adopt the less-preferred strategy.

(3) Their third alternative is to abandon or change their transaction. When the benefit they would receive under the less-preferred management strategy does not meet their expectations, they will abandon their original transaction, or modify it.

Organizational law, therefore, will only sway the parties' decision between an active- and passive-investor strategy at the margin. The margin becomes larger as organizational-law costs increase due to fewer organizational forms and less flexibility within each form.

The organizational-law costs for the passive-investor strategy will be the highest in jurisdictions that mandate the use of the corporation and provide little flexibility for the parties to contract subject to fiduciary duties for her participation, then it might have a chilling affect on her decision to participate. This is especially important with respect to investor/board members who are in the same industry as the fund's portfolio companies. Concerns with potential conflicts of interest will arise if the investor enters into a transaction with a portfolio company or takes for herself an opportunity that was within a portfolio company's line of business. Because limited partners that participate in a firm's business will probably have fiduciary duties similar to a member of a corporation's board of directors, there is no significant difference between the two organizational forms. The limited partnership form, however, will often allow parties to waive their fiduciary duties. See, e.g., David Rosenberg, Venture Capital Limited Partnerships: A Study in Freedom of Contract, 2002 COLUM. BUS. L. REV. 363, 388–89 (2002) (discussing how Delaware law allows a general partner to waive fiduciary duties through the limited partnership agreement).
out of default provisions. These jurisdictions are more likely to exhibit a market preference for active-investor funds than other jurisdictions.

The organizational-law costs for the active-investor strategy will be highest in jurisdictions that mandate the use of the limited partnership and provide little flexibility for the parties to contract out of default provisions. These jurisdictions are more likely to exhibit a market preference for passive-investor funds than are other jurisdictions.

Even when organizational law does not sway the parties' decision to the extent it would create a market preference for either strategy, it may still create transaction costs in the market. The parties will keep their preferred management strategy, but they will not be able to maximize their net benefit of that strategy. For example, in a traditional limited partnership jurisdiction, regulatory and market factors might strongly lead the parties to select an active-investor strategy. When their transaction lies at the active-investor end of the spectrum, they will, in fact, select an active-investor fund even though the traditional limited partnership is not best suited for investor participation. However, they will bear the transaction costs that come with the risk that their participation will subject them to personal liability. These costs cause the parties to operate their fund at suboptimal efficiency.

An argument can be made that a flexible organizational form would be the most efficient. For example, the limited liability company allows the parties the complete freedom to adopt whichever management strategy they prefer. Of course, such an organizational form may create costs for some transactions because it provides no “off-the-rack” default rules. In addition, more restrictive organizational forms, like the traditional limited partnership, may improve the efficiency of the reputational market for venture capital fund managers.

Naturally, one may ask where the United States fits into this discussion. U.S. venture capital funds are free to select among the various organizational forms that are available in their respective states of incorporation, including, without limitation, the general partnership, the limited partnership, the corporation, and the

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63 A very liberal limited partnership form would have a similar effect.
64 See infra Part IV.C.
65 They are also free to choose the state of incorporation.
limited liability company. However, although organizational law in the United States has provided the venture capital market with significant flexibility, U.S. tax laws have impinged on that flexibility and have had a very significant influence on the decision of venture capital funds to organize as limited partnerships.

Tax laws in the United States do not mandate the use of the limited partnership form, but they do make the corporation a more costly choice for the venture capital fund. U.S. tax laws only provide investors with pass-through taxation if they organize as some sort of unincorporated entity, such as a general partnership, a limited partnership, or a limited liability company, or if they incorporate and qualify for pass-through taxation under Chapter S of the Internal Revenue Code. Prior to the creation of a limited liability company form, this left the parties to choose among the general partnership, the S-corporation, and the limited partnership.

The general partnership was not an attractive choice because it did not provide limited liability. The S-corporation was not an attractive choice either. Although it provided both limited liability and pass-through taxation, it would not allow a fund to accept investment from a major source of capital in the venture capital market—institutional and corporate investors. The limited partnership form, however, was a relatively more attractive choice because it provided the investors (at least the limited partner investors) with both limited liability and unqualified pass-through taxation.

It is not difficult to imagine how U.S. laws providing tax advantages for the limited partnership might have contributed to a market preference for the passive-investor strategy. For example, if

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67 See Unif. P’ship Act §§ 13–15 (1914). There is an assumption that the parties place a high value on limited liability. The parties will only select a limited liability entity when “the value flowing from limited liability will exceed the costs resulting because [the entity] provides a less desirable governance structure than would some other business form.” O’Kelley, supra note 11, at 241–42.

68 See 26 U.S.C. § 1361(b)(1)(B) (2000) (“For purposes of this subchapter, the term ‘small business corporation’ means a domestic corporation . . . which does not . . . have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6) who is not an individual . . . .”); Gompers & Lerner, supra note 7, at 8–9 (showing that institutional and corporate investors are responsible for a large percentage of the investment in U.S. venture capital funds).
a fund manager wanted to establish a passive-investor fund, then she would prefer to organize as a limited partnership to prevent investors from interfering with her decisions. However, her potential investors might prefer a management strategy that allowed them some minimal level of participation in control. If the investors placed a greater value on pass-through taxation than on participation, then they would acquiesce to the fund manager’s desire for a limited partnership form and a passive-investor strategy. The greater the tax advantage a particular organizational form enjoys, the more the tax advantage functions like a law requiring the use of that organizational form.

The above example might represent the environment of the U.S. venture capital market many years ago. However, the laws of most states have evolved so that the limited partnership form is arguably flexible enough to allow parties to establish active-investor funds. More importantly, the advent of the limited liability company allows the parties to benefit from limited liability, unqualified pass-through taxation, and sufficient flexibility to pursue an active-investor strategy without risk of personal liability. Arguably, then, in the current U.S. venture capital market, regulatory and market factors will drive the parties’ decision between active- and passive-investor funds, and organizational law will have little or no influence. However, the early development of a market preference for a passive-investor strategy, for which organizational law may be partly responsible, might have an effect on the current market preference. In addition, network externalities might contribute to the continued use of the limited partnership, which in turn, may contribute to a preference against active-investor strategies.

D. The Fund Manager’s Role in Addressing Transaction Costs for Active- and Passive-Investor Funds

The fund manager can play an important role in reducing the transaction costs for both passive- and active-investor venture capital funds. Existing scholarship has already recognized that the fund manager reduces information costs for investors in passive-

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69 See supra Part III.A; infra Part IV.A.  
70 See supra Part III.B (arguing that even flexible limited partnership forms may negatively affect the creation of active-investor venture capital funds).  
71 For this Part, I assume that organizational law will have no effect on the fund manager’s ability to reduce the transaction costs for either strategy.
investor funds.\textsuperscript{72} My analysis in Part III.A suggests that the fund manager in a passive-investor fund will do more than reduce information costs—she will also reduce the monitoring costs created by the risk that investors will participate in control of the business.\textsuperscript{73} As discussed in more detail above, the investors will rely on the fund manager in a passive-investor fund to prevent the investors from participating in control of the fund, which efficiently reduces monitoring costs for the investors.\textsuperscript{74}

On the other hand, existing scholarship has not discussed whether fund managers in active-investor funds reduce transaction costs for the investors. I argue that the fund manager in an active-investor venture capital fund will indeed play a role in reducing the transaction costs that are specific to the active-investor strategy. The most obvious example may be the role she plays in reducing information and communication costs for the investors by serving as the gatherer and disseminator of information and by acting as the central coordinator of communications.\textsuperscript{75} The more interesting issue, however, is whether she reduces the transaction costs of team production, i.e., the costs of finding qualified investors and monitoring against shirking.\textsuperscript{76} Clearly, centralizing the responsibility for assembling a group of qualified investors with the fund manager would reduce transaction costs for firms in many situations. But it is not clear that centralizing the team production monitoring responsibility with the fund manager is an optimal strategy for the parties.\textsuperscript{77}

In their famous article \textit{Production, Information Costs, and Economic Organization},\textsuperscript{78} Armen Alchian and Harold Demsetz

\textsuperscript{72} The fund manager’s expertise provides the investors with access to investment opportunities they would otherwise not have. \textit{See} Klausner & Litvak, \textit{supra} note 2, at 55–56; Gilson, \textit{supra} note 2, at 1088. In addition, it is also clear that the fund manager of the passive-investor fund reduces the capital-raising costs the investors would otherwise incur in finding each other.

\textsuperscript{73} \textit{See supra} Part II.B.

\textsuperscript{74} \textit{See infra} Part IV.B.

\textsuperscript{75} \textit{See} Hansmann, \textit{supra} note 18, at 275.

\textsuperscript{76} \textit{See supra} Part III.B. For a discussion of team production in the context of the portfolio company, see D. Gordon Smith, \textit{Team Production in Venture Capital Investing}, 24 J. CORP. L. 949 (1999).

\textsuperscript{77} The issue is whether the fund manager can act as a mediating hierarchy. The role of the mediating hierarchs is “to balance team members’ competing interests in a fashion that keeps everyone happy enough that the productive coalition stays together.” Blair & Stout, \textit{supra} note 26, at 281.

\textsuperscript{78} Alchian & Demsetz, \textit{supra} note 16, at 777.
discussed shirking in the team production context. They advocated appointing a specialized monitor with the power to discipline the team members for their shirking. They also suggested that the specialized monitor should be assigned the firm’s residual claim to reduce the risk she would shirk her monitoring duties. Applying the analysis of Alchian and Demsetz to active-investor venture capital funds, I suggest that the fund manager can indeed play the role of specialized monitor, but her monitoring will be suboptimal.

First, Alchian and Demsetz emphasized that if the specialized monitor did not hold the entire residual claim, then “the cost of team production [would be] increased.” In other words, the monitor would have the greatest incentive not to shirk her monitoring duties only when she received the entire residual claim. The fund manager of a venture capital fund, however, will generally only receive a portion of the residual claim. This arrangement, according to Alchian and Demsetz, still gives the fund manager, as the monitor, some incentive to shirk.

Nevertheless, the parties may be willing to bear these costs. Assigning the entire residual claim to the specialized monitor may be the most efficient method to organize the monitoring function within the firm, but it is not necessarily the most efficient method to organize the firm. Assigning the fund manager only a portion of the residual claim will increase the risk of her shirking, but the firm will benefit from lower capital costs. In other words, the costs of a

79 Alchian’s and Demsetz’s solution to the team-production problems is referred to as the monitoring model. Smith, supra note 76, at 962; see Alchian & Demsetz, supra note 16, at 794; Blair & Stout, supra note 26, at 266. There are two other models that are widely discussed in legal and economics literature—the budget-breaking model and the bonding model. For good summaries of these three models, see Blair & Stout, supra note 26, at 268–69; Smith, supra note 76, at 962–65.

80 See Alchian & Demsetz, supra note 16, at 782.

81 See id. at 786.

82 This suggestion is based, at least partly, on what I observed occurring in the Taiwan venture capital market. See infra Part V.

83 Alchian & Demsetz, supra note 16, at 786.

84 It is standard in U.S. venture capital funds to give the fund manager a percentage of the fund’s returns as part of her compensation. See, e.g., Gompers & Lerner, supra note 7, at 64–65; Gilson, supra note 2, at 1089. The same is true in Taiwan. See infra note 214 and accompanying text.

85 Professors Blair and Stout have criticized Alchian and Demsetz for not emphasizing the possibility “that individuals will only want to be part of a team if by doing so they can share in the economic surplus generated by [the] team.” Blair & Stout, supra note 26, at 274.

86 Obtaining capital requirements from many investors in exchange for ownership interests is generally a less costly capital-raising strategy for a firm. See Alchian & Demsetz,
suboptimal monitoring strategy are tolerated because of the reduced costs of capital.87

Second, appointing the fund manager as the central monitor will not reduce all monitoring costs for the fund. In the active-investor venture capital fund contemplated by this Article, the fund manager is still the main source of non-capital input for the fund. Appointing the fund manager as the central monitor will reduce the costs the investors would otherwise incur in monitoring each other for shirking, but it will not reduce the costs the investors incur in monitoring the fund manager for shirking her duties as input-provider.88

Once again, the parties may be willing to bear these costs.89 If the fund manager’s sole function was to monitor against investor shirking, the investors would not receive the benefits of a professional fund manager’s input. In order to benefit from the fund manager’s expertise, the parties will bear the monitoring costs created by the risk that she will shirk her obligations as input-provider.90

Finally, the importance of disciplining team members when they shirk raises the most significant problems with the fund manager acting as the specialized monitor. First, it is difficult to see how the parties could structure their firm, under any organizational form, to

\[ supra \text{note 16, at 787.} \]

87 Another strategy of the active-investor firm is to minimize the number of investors so they have more incentive to contribute and less incentive to free-ride. Thus, the active-investor fund will seek a precarious equilibrium between a number of investors that is large enough to reduce capital costs and a number that is small enough to reduce incentives to free-ride.

88 Professors Blair and Stout suggest that the board of directors in a close corporation would not work well as a mediating hierarchy. See Blair & Stout, supra note 26, at 281. Because the board members are too closely aligned with the investors, they would favor the investors over other team members, such as employees. See id. Similarly, the fund manager of a venture capital fund is a contractual agent and non-capital input-provider. Thus, she would be too conflicted to act alone in the role of mediating hierarchy. See infra note 92 and accompanying text (addressing the fund manager’s conflict of interest when acting as a mediating hierarchy). A more balanced approach might be for the fund manager to partner with the investors/board as the mediating hierarchy.

89 In other words, they incur agency costs to address their team/production costs. See Blair & Stout, supra note 26, at 283 (“[T]eam members who adopt a mediating hierarchy may in some cases gain more from constraining shirking . . . than they lose to agency costs.”).

90 Admittedly, it would be possible for the fund to split the monitoring function and the managing function between two agents. The argument against such a strategy would be that it would require the fund to incur the costs of compensating a specialized monitor and a fund manager. It might be more efficient to reduce the fund manager’s incentives to shirk by giving her a portion of the residual claim.
allow the fund manager to "fire" an investor or reduce her right to distributions. Second, the undefined nature of the investors' obligations makes it difficult to determine exactly when an investor should be disciplined for failing to provide non-capital input.\textsuperscript{91} Moreover, because the fund manager is the primary provider of non-capital input, she is not an impartial judge in the matter.\textsuperscript{92}

It is possible that the risk of reputational sanction would provide the investor with sufficient incentive to cooperate with the fund manager's reasonable requests for non-capital input. Thus, although the fund manager might not have the power to discipline investors, she will have the power to disclose the investor's shirking to the other team members who will then decide whether to mete out reputational sanctions.

Relying on reputational sanctions to discipline investors also takes the power to discipline investors away from the fund manager and puts it in the hands of the investors. The investors, as compared to the fund manager, are arguably more impartial judges of a particular investor's failure to contribute than they are of the fund.\textsuperscript{93}

Because of the problems the parties will encounter with disciplining investors, they might well choose to dispense with a discipline-centered monitoring model of team production, adopting a

\textsuperscript{91} The investors in an active-investor venture capital fund would engage in shirking, i.e., avoiding an obligation, only in the broadest sense of the term. The inevitable nature of this type of firm means that the investors will likely remain idle until their input is sought. Even when an investor's input is requested, she will be under no obligation to contribute at any specific instance. This sort of problem is common in the team-production context. \textit{See} Blair, \textit{supra} note 35, at 399 ("Because inputs are complex and may not even be well understood at the beginning of the enterprise, it is difficult or impossible to write contracts among the team members specifying what each is to contribute."). Thus, an investor in this type of active-investor firm engages in shirking not by specific instances of sloth, selfishness, or lack of effort, but in her overall failure to make the general, undefined contribution to the firm that the parties had expected when the firm was organized. This situation is analogous to the employee team member whose main duty is to respond to the requests of her supervisor. The significant difference in the two situations is that the supervisor can easily discipline the employee by dismissing her or reducing her compensation, but the fund manager cannot easily discipline the investor in the same manner.

\textsuperscript{92} Although investors may provide expertise, deal access, and industry connections, they expect the fund manager to shoulder most of these responsibilities. Thus, there may be some conflicts between individual investors and the fund manager regarding whether the fund manager's expectation of investor input in a particular situation was reasonable. For a similar analysis on a conflicted hierarchy in the public corporation context, see Coates, \textit{supra} note 25, at 844–46 (arguing that the board may not be a completely disinterested mediating hierarch because management will often dominate the board).

\textsuperscript{93} The investors might not have direct conflicts in the dispute, but the fact that they are also non-capital input providers makes them less than completely impartial.
reward-centered monitoring model instead. Under the reward-centered model, investors would contribute because their contribution would result in a reward, not because their failure to contribute would result in a penalty.

An investor's "reward" might come in the form of an enhanced reputation with her fellow investors. In fact, we can easily imagine that an active-investor venture capital fund functions as a club where investors have the opportunity to make beneficial business connections with other investors and with the fund's portfolio companies. A corporate investor's contribution to the fund or portfolio company serves to display her worthiness to other corporate investors. There is a peacock effect, so to speak. This may explain why some U.S. venture capital funds use investor advisory boards to gain access to deals and expertise. Board meetings give the investors a means to make their contributions to the fund readily observable to the other investors.

The fund manager might also directly administer rewards to contributing investors. For example, the fund manager might give the investor an opportunity to invest in her new, hot fund. The fund manager might also cause one or more of the fund's portfolio companies to enter into transactions with the investor, or at least make the investor's contributions known to the portfolio companies. In a more sinister example of the fund manager's power to reward fund investors, she might allow the investor access to proprietary or confidential information obtained from the portfolio companies.

Of course, the reward-centered model might create costs that arise from the risk that the fund manager would not reward an investor when she has made a contribution. However, because board meetings will provide the investor with a low-cost opportunity to disclose that the fund manager has not carried through with the

94 A reward that is distinct from the derivative reward they would receive because the fund had benefited from their contributions.

95 See infra Part V.C (discussing the Taiwanese example).

96 See supra note 15 and accompanying text.

97 Scholarship has generally focused on the efforts of the fund manager to convince current investors to invest in her new fund. See, e.g., Black & Gilson, supra note 49, at 256. Surely, however, there are situations where the investor is the one who must convince the fund manager to allow her to invest in the new fund. We generally assume that the investor's money will always be welcome for a new venture. But when an investor is to be active in the enterprise, her behavior in previous enterprises becomes important when deciding whether to let her invest. Gilson, supra note 2, at 1092 ("If a GP [i.e., the investor] behaves opportunistically toward entrepreneurs in connection with previous portfolio company investments, it will lose access to the best new investments.").
expected reward, the prospect of reputational sanctions against the fund manager will reduce the risk that she will fail to administer a reward when the circumstances require it.

Regardless of whether the parties adopt a discipline-centered model, a reward-centered model, or a combination of the two, the fund manager in an active-investor fund will monitor against shirking, will facilitate the sanction of uncooperative team members, and/or will facilitate the rewarding of contributing team members.\footnote{In addition, she serves as the gatherer and disseminator of information and as the central coordinator of communications.} Although the fund manager may be a suboptimal monitor of team production, the parties may be willing to bear the costs of suboptimal monitoring in order to benefit from other aspects of the active-investor strategy.

\textit{E. Conclusion}

Part III has demonstrated that organizational law can influence a market preference for an active- or passive-investor strategy when it provides fewer choices of organizational form and less flexibility within each form. Even when organizational law does not influence a market preference, it may still create suboptimal transactions by forcing the parties to bear the costs of their preferred management strategy.

In addition, this Part has suggested that the fund managers in both active- and passive-investor venture capital funds play a role in reducing the transaction costs that are specific to each management strategy. The fund manager in a passive-investor fund will monitor for investor passivity and prevent investors from participating in control. The fund manager in an active-investor venture capital fund will monitor against shirking, will facilitate the sanction of uncooperative team members, and/or will facilitate the rewarding of team members.

\textbf{IV. THE PASSIVE-INVESTOR VENTURE CAPITAL FUND—THE ROLE OF THE LIMITED PARTNERSHIP CONTROL RULE}

It is classic hornbook law that a limited partner will lose her limited liability if she engages in control of the firm’s business.\footnote{\textit{WILLIAM A. GREGORY, THE LAW OF AGENCY AND PARTNERSHIP 440 (3d ed. 2001)} (“If a limited partner takes part in the control of the business, he becomes liable as a general partner.”)
This is called the “control rule.” Part III, above, briefly discussed how the control rule affected the parties’ choice between active- and passive-investor strategies when they were planning to establish a venture capital fund. However, even when the parties have selected a passive-investor strategy for their fund, there is still a risk that one or more investors will attempt to control decision-making at some point during the life of the fund. The existence of this risk creates monitoring costs for the investors. The question presented in this Part is whether the control rule reduces these monitoring costs for passive-investor firms.

At first blush, the control rule would seem to add value to the passive-investor fund by reducing monitoring costs.\(^{100}\) The control rule’s threat to sanction investors for participating in the firm’s business reduces the need for the investors to monitor each other against the possibility that one of them will gain effective control of the firm’s business.\(^{101}\) The monitoring costs are passed on to creditors to a certain extent, but the creditors are allowed to hold the investor who has participated in control personally liable for the firm’s obligations. Although one may argue that the control rule provides an underserved windfall to creditors,\(^ {102}\) a better analysis would be that it provides creditors with incentives to police investor passivity for the firm.

Despite the foregoing analysis, the control rule may actually do little or nothing to reduce monitoring costs in U.S. venture capital funds for two reasons. First, the control rule has been so significantly diluted in the United States that it does not substantially discourage investor participation (Part IV.A). Second, even if we assume the control rule discouraged investor

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\(^{100}\) Professor Ribstein argues that “[t]he control rule may work better than a provision in [a] limited partnership agreement forbidding the limited partners from managing.” LARRY E. RIBSTEIN, UNINCORPORATED BUSINESS ENTITIES 386 (3d ed. 2004).

\(^{101}\) This assumes that a court would consider a limited partner’s effective control over the general partner as participating in the control of the business. See CALLISON & SULLIVAN, supra note 44, § 23:5 (commenting that even with the safe harbor for advising the general partner, “there can be a factual question concerning whether a limited partner truly provides advice or whether, because of financial leverage or for other reasons, the limited partner instructs the general partner concerning the partnership business”); see also GREGORY, supra note 99, at 440 (“It is remarkably unclear just how much review, advisory, or veto power may be employed by the limited partner before he is deemed to be participating in the management of the enterprise.”).

\(^{102}\) At least to those creditors who have not reasonably relied on the credit of the limited partner.
participation, it is redundant in venture capital funds because the fund manager/general partner will police investor passivity (Part IV.B). On the other hand, although a strong control rule may not significantly reduce monitoring costs, it may add value by increasing the efficiency of the market and the reputation of venture capital fund managers (Part IV.C).

A. Does the Control Rule Actually Discourage Investor Participation?

The control rule does not require investor passivity nor does it prevent investor participation in the management of the firm's business. More accurately, the control rule creates a risk that an investor who participates in the business of a limited partnership will forfeit her limited liability because she has engaged in “control” of the firm's business. The existence of this risk does not necessarily mean that the investor will abstain from participating in the business of the firm even when the parties have selected a passive-investor strategy. She will decide whether to participate based on her assessment of the risks and the potential rewards for engaging in any particular activity.

The control rule's influence on investor participation during operation of the firm's business will be somewhat different from its influence during the firm's formation. During the formation stage, a strong control rule will prevent investors from institutionalizing and creating formal mechanisms for investor participation in decision-making, which will discourage them from choosing an active-investor strategy. However, even when a strong control rule coerces the parties to select a passive-investor strategy at the formation stage, it will not completely prevent investor participation once the firm begins operating.

During the operation of a passive-investor firm, investor participation in control of the business will occur when an investor, or group of investors, believes the general partner should take a specific course of action. At this stage, the investor will be able to make an assessment of the benefits of her proposed course of action, which she can then weigh against the risk that persuading or forcing the general partner to implement the action will violate the

103 See supra Part III.B.
control rule. Because we can anticipate that there will be times when an investor will determine that the benefits of her participation will outweigh the risk of violating the control rule, limited partners in passive-investor firms will sometimes participate even when there is a strong control rule. If we expect some participation by limited partners under a strong control rule, a weak control rule would make participation even more likely.

The control rule in the United States has undergone several evolutions that make it less likely that an investor's participation will subject her to the control rule's sanction of personal liability. Revisions of the Uniform Limited Partnership Act (ULPA) in 1976 and 1985 have progressively watered down the control rule. The 2001 version has deleted the control rule entirely.

The original version of the ULPA did the most to discourage investor participation with its broad threat of personal liability in the event a limited partner engaged in "control of the business"—a phrase that was not defined. The 1976 RULPA introduced a new control rule that was somewhat more lenient than the original formulation, but still broad enough to discourage most investors from participating in the firm's business. The 1985 RULPA went even further in narrowing and diluting the control rule so that it arguably did little to discourage investor participation.

Under the 1976 RULPA, the control rule was qualified, but it was still relatively strict. It prohibited limited partners from participating in control of the partnership's business if such participation was "substantially the same as the exercise of the powers of a general partner." The 1976 RULPA did not provide

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104 See supra note 101 (discussing whether an investor's effective control over the general partner constitutes participation in control of the business).

105 See Ribstein, supra note 100, at 386 ("The control rule has been gradually whittled away by the expanding 'safe harbor' exceptions and the reliance requirement . . . .").


107 UNIF. LTD. P'SHIP ACT (1916).

108 Id. § 7.


110 RULPA 1985, supra note 61, § 303(a).

111 RULPA 1976, supra note 109, § 303(a). The 1976 RULPA also provided that even when a limited partner did not participate in control that was substantially the same as the exercise of a general partner's powers, she would still lose her limited liability if she did engage in some control and the claimant transacted business with the partnership with knowledge of the limited partner's participation in control. Id.
any guidelines with respect to what sort of activities should be considered “substantially the same” as the exercise of a general partner’s powers, but it did provide a safe-harbor list of activities that would not be considered control.112 The safe-harbor list included activities such as advising the general partner and voting on major changes to the partnership, but it did not include voting on other business decisions of the partnership.113

The 1985 RULPA, which has been adopted by forty-six states and the District of Columbia,114 further weakened the control rule.115 The 1985 version of the control rule would not subject a limited partner to personal liability unless she participated in the control of the business and the claimant reasonably believed her to be a general partner.116 This formulation of the control rule would not significantly discourage investor participation in the firm’s business because the limited partner, even when she engaged in activities that were clearly control, could avoid sanction if she took measures to prevent a person who transacted business with the partnership from believing she was a general partner.117 Thus, there is a relatively low probability that a limited partner’s participation in control of the firm’s business would violate the prevailing control rule in the United States.118

112 Id. § 303(b).
113 Id.
114 See STEVEN C. ALBERTY, ADVISING SMALL BUSINESSES § 6:32 (2006). This includes Delaware. Id.
115 See Joseph J. Basile, Jr., Limited Liability for Limited Partners: An Argument for the Abolition of the Control Rule, 38 VAND. L. REV. 1199, 1228 (1985) (“[T]he Commissioners have recommended to the states an erosion of the control rule by the approval of new section 303 . . . .”).
116 RULPA 1985, supra note 61, § 303(a).
117 “If a limited partner wears a T-Shirt to every meeting with a person dealing with the partnership stating that s/he is NOT A GENERAL PARTNER, then they will never incur estoppel liability.” Carter G. Bishop, The New Limited Partner Liability Shield: Has the Vanquished Control Rule Unwittingly Resurrected Lingering Limited Partner Estoppel Liability as Well as Full General Partner Liability?, 37 SUFFOLK U. L. REV. 667, 667 (2004) (quoting, with reference to the 2001 RULPA version of the control rule, Marty Lubaroff’s “T-Shirt rule” as recalled by Robert Keatinge). The same could be said about the 1985 RULPA version of the control rule.
118 The 2001 revisions of the RULPA are even more lenient and effectively allow limited partners to freely participate in control without the threat of unlimited liability. See UNIF. LTD. PtSHIP ACT § 303 (2001). Professor Carter Bishop argues that the RULPA 2001 still leaves open the possibility that a limited partner who engages in control would be personally liable for partnership debts as a general partner or under an estoppel theory. Bishop, supra note 117, at 675–76. Daniel Kleinberger argues that personal liability for limited partners under Professor Bishop’s theory may be possible, but it is unlikely. Daniel S. Kleinberger, The Reporter’s Rejoinder, 37 SUFFOLK U. L. REV. 967, 968–69 (2004).
In addition to assessing the probability that her actions would violate the control rule, an investor analyzing her overall risk of participating in the firm’s business would also assess the magnitude of her potential liability. In fact, venture capital funds may not engage in the sort of activities that would result in extensive liabilities for the fund. Because the investor’s personal liability would not come into play unless the fund could not meet its obligations, the investor who participated in the business of the venture capital fund in violation of the control rule would not risk incurring liability of a large magnitude. Thus, the control rule would do little to prevent investor participation in U.S. limited partnership venture capital funds because there would be a very low probability that the investor’s activities would actually violate the prevailing control rule and the magnitude of her potential liability would be very small.

Once the investor has performed an assessment of the risks of her participation in control, she would weigh those risks against any benefit she stood to gain from her participation. Her benefit would be either derivative or private. It would be derivative if her control was intended to benefit the firm. For example, the investor uses her influence to cause the fund to invest in a start-up biotechnology company because she believes it will produce great returns for the fund in a few years. In contrast, her benefit would be private if her control was intended to benefit herself and not the fund. For example, the investor uses her influence to cause the fund to invest in a start-up biotechnology company of which she is the controlling shareholder.

If her benefit was private, then there would be a greater incentive for the investor to risk sanction under the control rule because she would capture all of the benefit. If her benefit was derivative, on the other hand, then there would be less incentive for her to risk violating the control rule by participating in control. She would bear the entire cost of running afoul of the control rule, but only receive her pro rata share of the benefit. If she were a large investor, then the benefit of her participation might be worth the risk. But if she only owned a small percentage of the entire capitalization of the fund, then she would be less likely to

119 See Sahlman, supra note 6, at 490 (“The consequences of unlimited liability are minor, however, because venture-capital partnerships typically do not borrow, nor are they exposed to the risk of having liabilities in excess of assets.”).
participate. Thus, in jurisdictions where a watered-down control rule creates only minimal risks of personal liability for investors, the parties can reduce the risk of investor control by structuring their firm so that each investor only holds a small percentage of the total capitalization. Such a strategy, however, would not be effective where the control rule creates virtually no risk of personal liability.

Overall, the current state of the control rule in the United States does little or nothing to prevent investor participation in control of limited partnership venture capital funds because investors can easily avoid violating the control rule while still engaging in control activities. Consequently, the investors would still bear the costs of monitoring to ensure that none of them participates in control. Hence, the prevailing control rule in the United States does little or nothing to reduce the monitoring costs for the investors in passive-investor funds.

B. Is a Strong Control Rule Unnecessary for Enforcing Investor Passivity?

The immediately preceding section discussed how the prevailing control rule in the United States does not reduce monitoring costs for the investors because it does not effectively prevent investor participation in limited partnership venture capital funds. That conclusion at least hints at the possibility that a strong control rule would reduce the monitoring costs for the investors in venture capital funds. However, a strong control rule would not reduce monitoring costs for the parties—not because it would fail to discourage investor participation, but because it would be a superfluous check on investor control.

In limited partnership venture capital funds, the general partner/fund manager will enforce investor passivity. Because the general partner will enforce investor passivity only when she has the proper incentives, a strong control rule will only reduce transaction costs for the parties if it reduces the costs of incentivizing the general partner.

The general partner will have the proper incentives to prevent

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120 Of course, this will not prevent a group of investors from acting together when the costs of collective action are low.
121 See supra Part III.A.
investor influence only when she has invested in her own competence. For her to choose her own decisions over the will of an investor, she must be confident in her own abilities. This confidence will come from investments she makes in experience, research, human resources, and so on. The general partner’s investments in her competence and the investors’ *ex ante* investigation and evaluation of the general partner’s competence are transaction costs for the parties.

It is clear, however, that the existence of a strong control rule will not allow the parties to avoid these costs. Indeed, the very nature of their proposed business relationship—a passive-investor venture capital fund—makes the general partner’s expertise an absolute requirement. Therefore, even a strong control rule would do nothing to reduce transaction costs of the general partner’s investment in her competence and the investors’ evaluation thereof because they would engage in these activities nonetheless.

In addition, the general partner will have the greatest incentive to prevent investor participation only when she receives an incentive-based compensation package. When her compensation is based on the success of the fund, substituting the will of the investor for her best judgment will cost her financially, or at least she will perceive it that way when she has invested in her competence. In contrast, if she receives fixed compensation, she will have less financial incentive to resist investor control. The argument, then, is that a strong control rule that effectively discourages investor control would allow the parties to avoid the transaction costs of incentive-based compensation.¹²²

A closer analysis, however, shows that the existence of a strong control rule would not obviate the need for parties to bear the transaction costs of an incentive-based compensation package. The parties would still use incentive-based compensation to address potential shirking by the general partner. Of course, the incentive-based compensation that is designed to discourage the general partner from shirking may not discourage the general partner from succumbing to all possible instances of investor influence. When a general partner shirks, she only stands to gain the value of her time. She may use that time to engage in other money-making activities or she may use it to engage in leisure activities.

¹²² Providing the manager with a share of the profits is a transaction cost because it reduces the return of the investors. *See Easterbrook & Fischel, supra* note 10, at 9.
Incentive-based compensation is designed to discourage the general partner from shirking by making her bear at least some of the costs of her shirking. The incentive-based compensation will be an effective deterrent against shirking when it causes the general partner's costs of shirking to exceed the benefits of shirking. Ideally, the investors will give incentives to the general partner in an amount that is sufficient to deter shirking, but no more.

In contrast, a general partner will succumb to an investor's influence against her better judgment only when she receives some private benefit from the investor, i.e., a bribe. When the general partner's incentive-based compensation is designed to cover the value of her shirking, it may not cover the amount of the bribe, which means it will not be an effective deterrent against investor influence. It is in these instances that a strong control rule reduces the transaction costs for the parties. A strong control rule that discourages the investor from attempting to exert her influence obviates the need for the parties to increase the general partner's normal incentive-based compensation to account for potential bribes.

There are other forces that encourage the general partner to resist investor control even when she does not receive incentive-based compensation. Because the general partner risks personal liability for the obligations of the firm, she will likely not make a practice of giving in to the wishes of an investor over her best judgment. Actually, the fact that the general partner risks personal liability is another reason why investors will be discouraged from engaging in control under a strong control rule. When the general partner is named as a defendant in a lawsuit, it seems very likely she will sell-out the investor who has participated in control.

Reputational concerns may also cause the general partner to resist investor control. If she adopts the investor's decisions, which she perceives to be inferior to her own, then she will anticipate inferior fund performance. She knows that poor fund performance will eventually hurt her efforts to raise capital for a

123 See RIBSTEIN, supra note 100, at 386 (stating that the general partner will want to prevent limited partner control because of her personal liability for the firm's obligations).

124 See Rosenberg, supra note 62, at 398 (“Investors in these funds do not rely on legal safeguards or the threat of litigation to protect their interests, but rather on the strong incentives created by the venture capitalists’ need to protect their own reputations.”).
new fund.125

In summary, a strong control rule may provide some marginal protection against investor control in situations where the general partner stands to receive a private benefit that exceeds her risk of personal liability, her reputational costs, and any losses under her incentive-based compensation package.126 Because the risk of such a large bribe is remote, it is unlikely that the parties would be able to efficiently use incentive-based compensation to account for it. Thus, a strong control rule reduces these residual losses.

C. Does the Control Rule Improve the Efficiency of the Market for Reputation?

The market for reputation for venture capital fund managers plays an important function in policing against fund manager opportunism.127 The role the reputation market plays in ensuring the competence of fund managers is also critical.128 After all, an honest fund manager will not make money for the investors unless she is also competent. The main method by which the market judges the competence and effectiveness of a fund manager is evaluation of her past performance.129

The information costs of determining the competence of fund

125 See Gilson, supra note 2, at 1074–75 ("[T]he performance of a GP's prior funds will be an important determinant of its ability to raise capital for a new fund . . . .").

126 It should be noted that in addition to resisting investor control when she is properly incentivized, the general partner will also resist the control of any outsider. It has been argued that the control rule protects creditors of the limited partnership by ensuring the general partner, who is bonded by the risk of personal liability, will not transfer control to the limited partners. See Larry E. Ribstein, Limited Liability and Theories of the Corporation, 50 Md. L. REV. 80, 93–94 (1991). Professor Larry Ribstein has criticized that argument. Id. He has asserted that the control rule does not ensure control and will only be exercised by the general partner because it does not prevent the transfer of control to non-limited partners. See id. Indeed, it is true that the control rule does not prevent transfer of control to non-investors, but my analysis in Part IV.B indicates that the creditors of a limited partnership benefit from the efforts of the investors to incentivize the general partner. When they do so, the general partner will resist both investor and outsider control, ensuring the creditor that those persons who are bonded by the risk of personal liability will be the only persons who engage in control. See supra Part IV.B.

127 Gilson, supra note 2, at 1090 (“Thus, the limited partnership’s fixed term assures that opportunist behavior by the GP . . . will be punished through the reputation market when it seeks to raise the successor funds that justify the GP’s investment in skill and experience in the first place.” (citation omitted)).

128 Sahlman, supra note 6, at 502 (“[B]y agreeing explicitly to have their performance reviewed . . . if they engage in opportunistic acts or are incompetent, they will be denied access to funds.”).

129 Gilson, supra note 2, at 1074–75.
managers based on past performance increase significantly when an organizational form allows investors to participate in venture capital funds. Prospective investors in a fund manager’s new fund will not know what portion of the fund manager’s prior successes, or failures, was attributable to her, and what portion was attributable to the investors in her earlier funds. Although it is possible that there was no investor participation or influence in the manager’s earlier funds, the prospective investors in the new fund will incur costs in determining this fact and the fund manager will incur costs in signaling this fact to the prospective investors. If there were an effective and cost-efficient means for the fund manager to signal to potential investors that her earlier fund was a passive-investor fund, then these transaction costs would be significantly reduced.

Organizational form can affect the fund manager’s ability to signal her competence to potential investors. When a fund’s organizational form precludes investor participation, the market knows that the fund’s successes were due to the competence of the fund manager, and not the fund’s investors. In contrast, when an organizational form makes it difficult for the parties to completely prevent investor participation, the market cannot readily know whether the fund’s successes were solely attributable to the fund manager or whether the composition of investors contributed to its success.

Because limited partnership law has traditionally given the investors, i.e., the limited partners, no right to participate in the management of the fund, when a prospective investor sees “LP” attached to a fund manager’s previous fund, she can safely assume the fund was a passive-investor fund. With this information, the prospective investor’s evaluation of the performance of the fund manager’s previous fund gives her a relatively accurate assessment of the fund manager’s competence.130

Admittedly, the “LP” moniker is not always an accurate signal of investor passivity. The more lenient a jurisdiction’s control rule is, the more it enables the parties to structure their fund as an active-investor fund. In these jurisdictions, because the control rule has been so substantially qualified,131 the words “limited partnership” do not necessarily indicate a passive-investor fund. In these

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130 At least she does not have to discount her investment to account for the possibility that the investors contributed to the previous fund’s success.

131 See supra Part IV.A.
jurisdictions, the “LP” moniker is a weak signal of investor passivity.

Therefore, a strong control rule improves the efficiency of the market for reputation, which brings additional benefits to a venture capital market. First, it creates greater incentives for the fund managers to invest in their competence. If the fund manager could not adequately signal to the market that her past successes were her own, then prospective investors in her new funds would tend to discount the fund manager’s contributions to the success of the earlier funds to account for possible contributions by investors. On the other hand, if the manager’s previous funds suffered any failures, then the new potential investors would tend to allocate all the fault of such failures to the fund manager. This means the fund manager would share the upside reputational rewards, but bear all the downside reputational risks. Because she would not capture all of the net reputational benefit of any investment she makes in her competence, her incentive to make such an investment will be dampened. If, on the other hand, she is able to signal to the market through use of the “LP” moniker that she alone is responsible for her fund’s successes, then she will receive a greater portion of the net reputational benefit of any investment she makes in her competence. This gives her a greater incentive to invest in her competence.

Because a limited partnership with a strong control rule gives fund managers a greater incentive to invest in their competence, it improves the efficiency of the venture capital market in several ways. The venture capital market as a whole will benefit from the existence of fund managers who are properly incentivized to invest in their competence. In addition, when a fund manager is invested in her competence, she will be more likely to resist investor interference in her decision-making, which reduces the transaction costs of establishing passive-investor funds.132

A strong control rule will also assist in screening out weak fund managers in the market. If the fund manager is not fully invested in her competence, then she will be more susceptible to allowing investors to contribute to the management of the fund and may even solicit their help to bolster her performance. A strong control rule discourages investor participation in these situations and, thus,

132 See supra Part IV.A.
forces the fund manager to sink or swim on her own. In this way, a strong control rule contributes to the efficiency of the market by helping to weed out weak fund managers.

D. Conclusion

The analysis in this Part demonstrates that a weak control rule does little to reduce the transaction costs for a passive-investor venture capital fund. Because a weak control rule does not discourage investor participation in control, the investors will still bear the costs of monitoring to ensure that none of them participates in control. In addition, a weak control rule contributes to inefficiencies in the market for reputation for fund managers because it reduces the effectiveness of the “LP” moniker as a signal of investor passivity.

On the other hand, a strong control rule with sanctions severe enough to discourage investor control reduces the monitoring costs for the parties, but only marginally. A strong control rule will only affect situations where incentive-based compensation, risk of personal liability for the fund manager, and/or reputational concerns for the fund manager do not provide her with sufficient incentives to enforce investor passivity and resist investor influence.

However, a strong control rule provides more than just marginal contributions to the market for reputation. A strong control rule makes the “LP” moniker an efficient method for the fund manager to signal to prospective new investors that the successes of her previous limited partnership funds were due to her efforts alone. This situation provides fund managers with incentives to invest in their competence, which contributes to a better venture capital market overall.

If a weak control rule does nothing to reduce transaction costs for passive-investor funds and a strong control does indeed reduce transaction costs for passive-investor funds, then why has there been a trend to water down the control rule? I speculate that the trend started prior to the advent of other organizational forms that provided limited liability and pass-through taxation. When investors were seeking limited liability and pass-through taxation, their only choices were the S-corporation or the limited partnership.133 Because not all firms could qualify for S-corporation

133 See J. DENNIS HYNES & MARK J. LOEWENSTEIN, AGENCY, PARTNERSHIP, AND THE LLC:
status, they were essentially forced to use the limited partnership form.134

A limited partnership law with a strong control rule would have forced business organizations better suited for active-investor strategies firms to: (1) abandon their plans; (2) organize as passive-investor firms; or (3) organize as active-investor firms and bear the risk of the control rule. Thus, when the limited partnership was the only organizational form that provided both limited liability and pass-through taxation, the control rule created significant transaction costs in the market.

Now that limited liability companies allow investors to receive both pass-through taxation and limited liability without any limitation on control,135 a strong control rule no longer creates transaction costs in the market. Nevertheless, the momentum to weaken or destroy the control rule did not die down, even after the emergence of limited liability companies. Unfortunately, the progressive weakening of the control rule means that parties who wish to organize passive-investor firms cannot receive the benefits that a strong control rule may provide them.

Even if we assume that a strong control rule does not reduce costs for passive-investor firms or increase the efficiency of the reputation market, there still appears to be little justification for weakening the control rule. If a strong control rule created only costs and no benefits, then the participants in the market would simply choose the limited liability company. The limited partnership would eventually become an unused relic. As it stands now, the diluted control rule has effectively removed a choice for consumers in the market for business associations and thereby weakened the efficiency of the market.136
V. THE ACTIVE-INVESTOR VENTURE CAPITAL FUND—THE TAIWANESE EXAMPLE

As stated in the introduction to this Article, there is a proliferation of active-investor funds in the Taiwanese venture capital market. An examination of Taiwanese venture capital funds may inform our understanding of the factors that influence a market preference for active-investor venture capital funds. In addition, the Taiwanese venture capital market provides us with actual examples of the strategies that active-investor funds employ to reduce transaction costs and exploit the benefits of the active-investor model.

This part of the Article briefly explores how organizational law and other factors have contributed to the proliferation of active-investor funds in Taiwan (Part V.A). It then demonstrates how investors in Taiwanese venture capital funds are active in the management of their funds (Part V.B). Finally, it explores the strategies Taiwanese active-investor funds employ to maximize the net benefit of an active-investor fund (Part V.C).

A. The Determinants of Active-Investor Taiwanese Venture Capital Funds—Organizational Law and Other Factors

In Part III above, I suggested that a market preference for active-investor firms was more likely in a jurisdiction where the organizational-law costs for the passive-investor strategy were high. Organizational-law costs for passive-investor funds will be highest in jurisdictions that mandate the use of the corporate form and provide little flexibility for the parties to contract out of its default provisions.137 It appears that Taiwan meets these conditions, although not completely. It also appears that market conditions in Taiwan have been less conducive to the development of a market preference for passive-investor venture capital funds.

\footnote{complex. See Kleinberger, supra note 106, at 628–29. However, it could have been made certain and simple by making it stricter—leaving no doubt that any action by limited partners, save a short list of express safe harbors, would subject them to the risk of personal liability.}

\footnote{137 See supra Part III.C.}
1. Regulations Mandating the Corporate Form

Regulations governing and creating a Taiwanese venture capital market in 1983 expressly required venture capital funds to organize as corporations. When the regulations were revised in 1986, they allowed venture capital funds to organize as partnerships as well as corporations. However, Taiwanese partnership law was a poor fit for venture capital funds for several reasons. First, Taiwanese law did not have a partnership form similar to a U.S.-style limited partnership, which meant that investors in a Taiwanese partnership would be personally liable for the partnership’s obligations. Second, until 1998, Taiwanese partnerships were subject to double taxation and, therefore, held no tax advantages over corporations. Finally, Taiwan’s Civil Code allowed only natural persons to be partners. Much of the wealth available for investment in the Taiwanese venture capital market was held by enterprises. The Civil Code would have excluded these enterprises from investing in any venture capital funds organized as partnerships. Thus, without revisions to the Civil Code, the Taiwanese partnership would not have been a suitable choice for venture capital funds.

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140 Id. There was, however, a provision in the Civil Code for “dormant” or “undisclosed” partnerships, which protected passive-investors with limited liability. Id.

141 TAXATION & TARIFF COMM., MINISTRY OF FINANCE, REPUBLIC OF CHINA, GUIDE TO ROC TAXES 28 (2003).


143 As a sample, from the years 1996 through 2002, the percentage of enterprise investment in Taiwan venture capital funds was as high as 84.07% in 1996, but never went below its 2000 mark of 78.49%. TAIWAN VENTURE CAPITAL ASS’N, 2003 YEARBOOK 30 fig.C.8 (2003) [hereinafter TVCA 2003 ENGLISH YEARBOOK].

144 It should be noted that although Taiwan’s lawmakers did not choose to revise the Civil Code, they did in fact legislate exceptions to the Company Law to accommodate the emergence of venture capitalists. The Company Law had, at that time, an express limitation on the amount a company could use to invest in other companies. C.Y. Huang & Marc H. Sterling, Venture Capital: Legal and Tax Considerations, in TAIWAN TRADE AND INVESTMENT LAW 429, 435 (Mitchell A. Silk ed., 1994). The Statute Encouraging Investment, however, exempted venture capital funds from this limitation. See id. The creation of this exemption to the Company Law leads one to believe that the Statute Encouraging Investments could have also somehow modified the partnership form to accommodate the special needs of venture capitalists, such as by providing limited liability for passive-investors.
Because the participants in the Taiwanese venture capital market were understandably uninterested in organizing their funds as partnerships, the partnership option was deleted when the regulations were again revised in 1993.\textsuperscript{145} Later, in 2001, a law was enacted that superseded the original regulations governing venture capital funds in Taiwan.\textsuperscript{146} The new law no longer required venture capital funds to organize as corporations.\textsuperscript{147} Despite the fact that since 2001, venture capital funds in Taiwan have been permitted to choose freely among the various organizational forms provided for in the Company Law, they have continued, however, to organize as corporations.

2. Network Externalities and Path Dependencies That Channel Funds to the Corporate Form

One could argue that network externalities are responsible for the continued use of the corporate form in the Taiwanese venture capital market.\textsuperscript{148} Interestingly, the Company Law provides for an organizational form that is somewhat similar to the U.S. limited partnership form. The Taiwanese joint company, also called an “unlimited company with limited liability shareholders,” provides for two classes of investors—one with unlimited liability and one with limited liability.\textsuperscript{149} A limited liability investor has no right to “conduct the business of the company nor represent the company in its external affairs,”\textsuperscript{150} but will only be personally liable for the company’s debts when she causes a third party to believe she is an unlimited liability investor.\textsuperscript{151} She will not lose her limited liability simply for having approval rights or influence over the decisions of the unlimited liability investors. In this way, the joint company is very similar to a U.S. limited partnership with a weak control

\textsuperscript{147} The new law only requires the venture capital enterprise to be a “company.” Id. at art. 3.
\textsuperscript{148} Larry E. Ribstein & Bruce H. Kobayashi, Choice of Form and Network Externalities, 43 Wm. & Mary L. Rev. 79, 82 (2001) (“Firms may stick with organizational forms that provide networks of case law, forms, and other materials even if a move to a new organizational form would otherwise better suit their needs.”).
\textsuperscript{149} See GONG SI FA [COMPANY LAW] art. 114 (Taiwan).
\textsuperscript{150} Id. at art. 122.
\textsuperscript{151} Id. at art. 121.
rule.  

Importantly, because the joint company has no tax advantages over the Taiwanese corporation, it provides no additional incentive for venture capital funds to organize as joint companies except to accommodate a passive-investor strategy. Further, the joint company requires the drafting and negotiation of detailed contractual arrangements, while the corporate form is governed by a comprehensive set of default rules. Because Taiwanese businesspeople have traditionally favored simple contracts, the default rules of the Company Law have become a familiar and comfortable choice for them. This network externality has contributed to the continued use of the corporate form by Taiwanese venture capital funds.

One could also argue that the corporate form is the current organizational form of choice not simply because of network externalities, but also because it is well suited to the market preference for the active-investor strategy. Of course, the active-investor strategy is the preferred strategy only because of path dependent reasons—namely, the law forced the parties to use the corporate form for many years and the corporate form was less suited to a passive-investor strategy.

3. Organizational Law’s Influence on the Preference for Active-Investor Funds

In general, the historical rigidity of Taiwan’s Company Law would have made it difficult for parties to engage in the type of

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152 See supra Parts III.A, IV.A.

153 See supra notes 66–69 and accompanying text (discussing how U.S. tax law channels parties to use the limited partnership form for their venture capital funds).


155 See id. (discussing the preference in Taiwan against complex written agreements).

156 See Ribstein & Kobayashi, supra note 148, at 113 (stating that the “[f]ailure to move to a new standard may be attributable to the suitability of the default rules of the standard form” and not to network externalities).

157 See supra Parts III.A–C (arguing that the corporate form is more conducive to active-investor funds and less conducive to passive-investor funds).

innovative private ordering required to create passive-investor funds using the corporate form. 159 Yet, because Taiwan’s Company Law has long permitted a dual-class equity capital structure, 160 one could argue that it has provided sufficient flexibility for the creation of passive-investor funds. No doubt the preference for simple contracts and default rules in Taiwan would have discouraged the innovative use of a dual-class share structure, but if legal and market conditions were very favorable to the emergence of passive-investor funds, then we would expect that at least some funds would have experimented with the innovation.

The slow development of fiduciary duties in Taiwan may help explain the predominance of active-investor funds. 161 Without strong fiduciary duty constraints on directors, investors would generally be less willing to relinquish entire control of the board of directors to a fund manager. Of course, fiduciary duties are not always important in passive-investor funds. Limited partners in U.S. limited partnership venture capital funds often waive the general partner’s fiduciary duties, relying on the market for reputation and detailed contractual restrictions on the general partner’s behavior to protect their interests. 162 The market preference for simple contracts in Taiwan would discourage the use of detailed agreements to constrain fund manager opportunism, making fiduciary duties more crucial for a passive-investor strategy in Taiwan than in the United States.

In fact, weak fiduciary duties may have increased the attractiveness of active-investor venture capital funds in Taiwan. An investor would be more willing to be active in the management of her fund’s business by participating on the board of directors when weak fiduciary duty laws did not pose a significant risk of sanction. 163

4. Non-Organizational Law Factors

One can make a relatively strong argument that market
conditions in Taiwan have not been conducive to the emergence of passive-investor venture capital funds. A significant amount of the capital available for investment in Taiwanese venture capital funds belongs to corporate investors.\textsuperscript{164} Moreover, only a relatively small amount of institutional-investor capital is available for investment in venture capital funds due to regulatory restrictions.\textsuperscript{165} A market environment that lacks substantial institutional-investor capital, such as we see in Taiwan, would be less favorable to the emergence of passive-investor funds.\textsuperscript{166} Further, a market environment with a large number of corporate investors, as we see in Taiwan, may be more conducive to the active-investor strategy.\textsuperscript{167}

\textbf{B. Investor Activity in Taiwanese Venture Capital Funds}

In Taiwanese venture capital funds, the investors actually play a major part in the decision-making process. The investors control and dominate the fund’s board of directors by holding the vast majority of the seats on the board.\textsuperscript{168} Most fund management firms do not directly invest in the funds they manage, but may occupy one or two seats on the board through an agreement with the investors.\textsuperscript{169} In fact, investors do not always allow the fund manager to occupy a seat on the board.\textsuperscript{170}

\begin{itemize}
\item \textsuperscript{164} See TVCA 2003 English Yearbook, supra note 143, at 27–30 figs.C.5, 6, 7, & 8.
\item \textsuperscript{165} See id.
\item \textsuperscript{166} See supra Part II. (discussing why an abundance of corporate investors in the market may be more conducive to an active-investor strategy and an abundance of institutional investors may be more conducive to a passive-investor strategy).
\item \textsuperscript{167} See supra Part II.
\item \textsuperscript{168} It seems that most funds have boards that are made up of at least seven directors. See, e.g., Interview with Mr. ___ (anonymity requested), Venture Capital Mgmt. Co. G, in Taipei, Taiwan (July 9, 2004) (on file with author) [hereinafter Interview G] (noting that the board has seven to nine seats); Interview with Mr. ___ (anonymity requested), Venture Capital Mgmt. Co. H, in Taipei, Taiwan (July 15, 2004) (on file with author) [hereinafter Interview H] (indicating that the board has seven seats).
\item \textsuperscript{169} Interview with Mr. ___ (anonymity requested), Venture Capital Mgmt. Co. C, in Taipei, Taiwan (June 25, 2004) (on file with author) [hereinafter Interview C] (stating that the fund management company did not invest in the fund, but held one board seat as per agreement with the investors): see Lin Xing-Pei, Dong Shi Hui Dui Chuang Ye Tou Zi Gong Si Ji Xiao Yin Xiang Zhi Yan Jiu [The Impact of the Board of Directors on the Performance of Venture Capital Firms] 99–101 (2002) (unpublished master’s thesis, National Zheng Zhi University) (on file with author): Interview G, supra note 168 (noting that his management company usually owned less than five percent of the shareholding in the funds it managed and usually took one or two seats on the board of directors).
\item \textsuperscript{170} See Lin, supra note 169, at 99. In one particular example, a fund manager tried to occupy two seats on the board, but the investors would not allow it. See Interview with Mr. ___ (anonymity requested), Venture Capital Mgmt. Co. B, in Taipei, Taiwan (June 17 & 29,
It is apparently not uncommon, however, for the fund management firm to have indirect investment in the fund and, therefore, indirect representation on the board. The principals behind many fund management firms are wealthy people. They may invest in the funds themselves, through their family members, or through corporations that they control. This may allow the fund manager to indirectly garner one or more seats on the fund’s board of directors. Notwithstanding, the investors usually control the board of a Taiwanese venture capital fund.

It is common for the investors to play a significant role in the investment decisions of the venture capital fund through their participation on the fund’s board of directors. A Taiwanese venture capital fund will generally have two bank accounts, one account is for use in the daily operations of the fund and a second is for the fund’s investments. The investment account is usually in the care of a custodian bank. The fund manager cannot access this investment account without a resolution of the board of directors. Thus, the decision to invest is ultimately in the hands of the investors in their capacities as members of the board of directors.

The contractual agreement between the fund and the fund manager may give the fund manager a certain level of discretion to make investments. For example, Management Firm C reported that it had complete discretion to make any investment under $1 million (USD) without the approval of the fund’s board.

In contrast, the fund managers of some funds may still be required to obtain approval from the fund’s board for even the smallest investments, but the parties understand that this is simply

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171 See Interview with Mr. Ben C.Y. Liu, Attorney, InfoShare Tech Law Office, in Taipei, Taiwan (July 8, 2004) (on file with author) [hereinafter Interview with Mr. Liu].
172 See Interview B, supra note 170 (stating that the chairman of the fund management company was heavily invested in one of the funds); Interview H, supra note 168 (stating that the “partners” in the fund management company invested in their offshore fund and held three of seven seats on the board of directors, but in their Taiwanese fund, the partners would only hold one seat on the board).
173 See Interview B, supra note 170.
174 Taiwan’s Company Law has an interesting characteristic. Legal entities can be elected to serve on the board of directors. A legal entity that is elected to the board will appoint a natural person to sit on the board as its representative. The legal entity can remove and appoint the natural person at-will for as long as it holds the board seat. See COMPANY LAW, supra note 149, art. 27.
175 Interview B, supra note 170.
176 Id.
177 Interview C, supra note 169.
a formality. Management Firm B reported two interesting variations on this model. The first variation occurred in Management Firm B’s later fund, where all investments required board approval. However, the board did not actually meet or discuss investments under $700,000 (USD), and written board approval for these investments was given as a matter of course.178 For investments over $700,000 (USD), the board actually convened to evaluate, discuss, and vote on the fund manager’s investment proposal.179 The second variation occurred in Management Firm B’s earlier fund, where the fund manager was required to seek board approval for all investments, but special allowances were made for “urgent cases.”180 For these urgent cases, the fund manager was permitted to make the investments without board approval, and then report to the board after the fact.181

It was the lack of flexibility to deal with urgent cases in an expedited manner that most frustrated the interviewee of Management Firm A. Management Firm A was required to obtain board approval in every instance, whether or not the case required immediate action.182 The interviewee felt that in a competitive market, this process prevented the fund manager from taking advantage of certain opportunities.183

Even where a fund manager is given discretion to make investments under a certain dollar amount, such discretion may not be significant when the average investment usually exceeds that amount. Management Firm G reported that although it had discretion to make investments under $1 million (USD) without board approval, the average investment was around $3 million (USD).184 Thus, even when fund managers have some discretion to make investments without board approval, most investments will require a board resolution.

An important issue with respect to board approval of the fund manager’s investment proposals is whether the board members, who are the investors, are truly active in evaluating these

178 Interview B, supra note 170.
179 Id.
180 Id.
181 Id.
182 Interview with Mr. ___ (anonymity requested), Venture Capital Mgmt. Co. A, in Taipei, Taiwan (June 14, 2004) (on file with author) [hereinafter Interview A].
183 Id.
184 See Interview G, supra note 168.
investment proposals. After all, if the board simply acts as a rubber stamp, then the investors will be active in the management of the fund in name only, but not in practice. In fact, the boards of directors of Taiwanese venture capital funds are generally quite serious about reviewing their fund manager’s investment proposals, although there appears to be a continuum of board activity across the market.185

These interviews created a clear sense that the directors of Taiwanese venture capital funds did not simply rubber stamp their fund manager’s investment proposals. It was difficult to quantify how often boards rejected investment proposals. It was clear, however, that although rejections were relatively rare, they were certainly not considered aberrations. Management Firm A stated that rejection had occurred in less than twenty percent of its cases.186 Management Firm H also indicated that rejection did in fact occur, although the board might add conditions to investment proposals, or modify them instead of rejecting them outright.187 Even Management Firm G, which characterized board meetings as a “formality,” had experienced one rejection.188 Other firms that participated in the interviews reported that they had never experienced a rejection by the board.189

The apparently low rejection rates may be attributable to informal communications between fund managers and investors prior to formal board meetings. This type of informal communication with investors prior to board meetings seems to be quite common in the Taiwanese venture capital market. Some fund managers indicated that they spent a considerable amount of time and effort communicating with board members prior to board meetings.190

Management Firm B reported that it made special efforts to communicate with board members that it suspected might have

185 Two of the interviewees saw a positive correlation between the activity of fund investors and a slow market for good investment opportunities. See Interview A, supra note 182; Interview G, supra note 168.
186 Interview A, supra note 182.
187 Interview H, supra note 168.
188 See Interview G, supra note 168.
189 See, e.g., Interview C, supra note 169.
190 See Interview A, supra note 182 (reporting that informal communication with investors occurred in the previous management firm he worked for); see also Lin, supra note 169, at 69 (discussing how the fund manager involves the directors in the evaluation process, so there is no need to discuss the proposal once it comes before the board at a formal meeting).
doubts or concerns about an investment proposal. In addition, since board members tended to respect the opinion of other members who possessed expertise relevant to the investment proposal, communication with these board members was especially important.

In contrast, some fund managers, like that of Management Firm C, simply sent their investment proposals to the board members a week before the formal board meeting without later engaging board members in special informational meetings. Because the interviewee from Management Firm C also indicated that his fund’s board meetings were “paper” meetings, and not actual meetings, it may be that this fund’s place on the active-investor spectrum lies closer to the passive-investor end. Despite the example of Management Firm C, it is clear that, as a general proposition, fostering good relations and good channels of communications with investors is important for the fund manager to obtain approval of her investment proposals.

C. Maximizing the Net Benefits of the Active-Investor Strategy in Taiwanese Venture Capital Funds

The immediately preceding section demonstrated that investors in many Taiwanese venture capital funds are active in decision-making. We would expect to see these active-investor funds implementing strategies to reduce the transaction costs and maximize the benefits of active-investors. As discussed in Part III, in order to maximize the net benefit of an active-investor strategy, the parties will find investors whose qualifications make their participation in decision-making an asset, not a liability. In addition, the parties will adopt strategies to minimize shirking and maximize the non-capital contributions the investors make to the fund.

191 See Interview B, supra note 170.
192 See id.
193 See Interview C, supra note 169.
194 Id.
195 Compare Interview G, supra note 168 (expressing the importance of personal relationships), with Interview C, supra note 169 (noting the preference for paper meetings, but explaining that some communication occurs by telephone).
196 See supra Part III.B.
197 See supra Part III.B.
1. Finding Qualified Investors

Taiwanese fund managers generally place priority on investors that will add value to the fund and to the fund’s portfolio companies. The interviewee from Management Firm A said that as a general strategy, his firm sought investment from corporations with experience in the fund’s targeted investment industry.\(^\text{198}\) As an example, he reported that his management team was only seeking investors from the information technology industry for its new fund.\(^\text{199}\) There was a general expectation that the investors would be able to provide the fund’s portfolio companies with better access to human capital, industry connections, and possible merger opportunities.\(^\text{200}\)

Similarly, the interviewee from Management Firm D reported that his firm’s general strategy for raising capital was to maximize the synergies between the investors and the target portfolio companies.\(^\text{201}\) This firm also sought investors from the financial industry to provide possible underwriting contacts for the fund’s portfolio companies.\(^\text{202}\) In fact, securities firms will often invest in venture capital funds to generate business for their underwriting services.\(^\text{203}\)

The general strategy of Management Firm G was the same—to seek investors with backgrounds in the industry in which the fund planned to invest. At the time of the interview, Management Firm G was in the process of raising capital for a new fund that would specialize in investing in a particular industry.\(^\text{204}\) The interviewee expressed a desire to find an investor with experience in that particular industry so the fund could “leverage [the investor’s] resources.”\(^\text{205}\)

The interviewee from Management Firm B expressed his belief that fund managers in Taiwan generally put a priority on finding investors that would add value to their funds.\(^\text{206}\) Of course, a fund

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\(^{198}\) Interview A, supra note 182.

\(^{199}\) Id.

\(^{200}\) See id.

\(^{201}\) Interview with Mr. ___ (anonymity requested), Venture Capital Mgmt. Co. D, in Taipei, Taiwan (July 7, 2004) (on file with author) [hereinafter Interview D].

\(^{202}\) Id.

\(^{203}\) Id.

\(^{204}\) Interview G, supra note 168.

\(^{205}\) Id.

\(^{206}\) See Interview B, supra note 170. He recognized that attracting an investor with
manager might compromise this strategy when her deadline for raising capital is rapidly approaching. The interviewee from Management Firm G said that when his deadline was approaching, his focus changed from finding investors with desirable qualifications to excluding investors with poor reputations.207

Finding qualified investors is an important strategy not only for maximizing the value of investor input, but also for reducing conflicts between the fund manager and investors. Fund managers in Taiwan prefer corporate investors and try to exclude individual investors from investing in their funds because individuals generally create more problems for the fund manager. One fund manager said that individual investors did not deal with their investments professionally.208 Another fund manager felt that dealing with individual investors created problems for his firm because they had unrealistic expectations for large and quick returns.209

Of course, conflicts can arise even between qualified investors and fund managers. If a corporate investor appointed a junior member of its staff to represent it on the fund’s board, for example, then the fund manager might be less willing to make compromises than if she were dealing with a person with more experience and knowledge. The interviewee from Management Firm I related a particularly memorable anecdote. During one contentious moment with an investor board member, who was actually a junior staff member of a corporate investor, the board member emphasized her experience by stating that she was on the board of several funds. The experienced fund manager retorted, “I started doing this when you were [eight] years old.”210

These kinds of conflicts between fund managers and their investors regarding proposed business decisions seem inevitable. A fund manager who has invested in her competence will believe that her proposal is the best course of action for the fund. She will fight for her proposal, especially when a significant amount of her experience in the fund’s target industry was a good signal to other investors that this fund would be worthy of investment. Id.

207 See Interview G, supra note 168.
208 Interview B, supra note 170.
209 Interview A, supra note 182.
210 Interview with Mr. ___ (anonymity requested), Venture Capital Mgmt. Co. I and Board Member, Taiwan Venture Capital Ass’n, in Taipei, Taiwan (July 19, 2004) (on file with author) [hereinafter Interview I].
compensation is based on fund performance. This can lead to conflicts with the investors.

If the investors had excellent qualifications, the fund manager should be more amenable to compromise because she would recognize that the investors’ suggestions or objections must have some merit. Nonetheless, it would be reasonable to posit that the more qualified the fund manager was, i.e., the more she had invested in her competence, the more frustrated she would be when investors disagreed with her proposals. This kind of fund manager might be better suited to operating a passive-investor fund. Of course, market factors, regulatory factors, and organizational law might prevent her from doing so.

In fact, active investors seem to be a source of frustration for some fund managers in Taiwan. The interviewee of Management Firm G pined for the early days of Taiwan’s venture capital market when the board tended to defer to the decisions of the fund manager. The interviewee from Management Firm I expressed a similar sentiment. He said that because the investors dominated the board and the board was the highest authority in the corporation, the fund manager was relegated to a position of gathering information and generating deal flow. I interpreted this to mean that he felt his expertise was somewhat wasted in an active-investor fund.

2. Maximizing Non-Capital Contributions of the Investors

In Part III above, this Article suggested that an active-investor venture capital fund would rely on the fund manager to play a crucial role in coordinating and monitoring investor contributions to the team. In Taiwan, the contract between the fund and the fund manager typically provides the fund manager with a significant portion of the residual claim in the form of carried interest. This

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211 See supra Part IV.B.
212 This situation could lead to the fund manager providing skewed information to the investors.
213 See Interview G, supra note 168.
214 See Interview I, supra note 210.
215 See supra Part III.D.
216 Similar to the U.S. venture capital market, the Taiwanese fund manager’s compensation includes a management fee and carried interest. See supra note 84 and accompanying text. Some fund managers only receive their carried interest after the original capital has been returned to the investors. See Interview H, supra note 168; Interview with Mr. Liu, supra note 171 (stating that this arrangement is probably more feasible for fund managers that manage several funds, which allows them to survive temporarily on
compensation structure gives her the incentives to act as monitor and coordinator of team production for the fund. Of course, she will be a suboptimal monitor. Because she is not the sole residual claimant, her incentives to monitor will not be as intense.

A reward-centered monitoring model would not only mitigate some of the inefficiencies of assigning the monitoring function to the fund manager, but it would also allow the parties to avoid the difficulties of disciplining investors. There are some indications that Taiwanese funds increase the efficiency of their monitoring by adopting some sort of reward-centered model. Evidence suggests that some investors are at least partially motivated to invest in Taiwanese venture capital funds because of the prospect of winning the favor of another investor. In addition, some investors may be attracted by the prospect of getting new business or learning about new technologies through the fund. This, however, raises further questions about how the parties balance the interests of the fund and its portfolio companies against the interests of its investors. It is a complex interaction to say the least.

Thus, Taiwanese active-investor venture capital funds may not have an optimal approach to eliminate the transaction costs of their chosen management strategy. But, if the majority of Taiwanese venture capital funds select the active-investor strategy, which seems to be the case, then investors must be willing to tolerate the costs of a suboptimal monitoring strategy in order to reap the benefits that an active-investor venture capital fund provides. In

management fees alone). In some instances, a fund manager’s carried interest may be withheld until the investors have received certain return on their investment. After the year 2000, these types of “hurdle rates” began to appear in the Taiwanese venture capital market. See Interview with Mr. Liu, supra note 171. The early funds managed by Management Firm G contained no hurdle rates, but its more recent funds had hurdle rates of approximately eight percent because of the changes in the market. Interview G, supra note 168. Some Taiwanese funds have hurdle rates as low as two percent. Interview D, supra note 201. In general, changes in the market are affecting hurdle rates—investors are asking for higher hurdle rates. See id.

217 See supra Part III.D.
218 See supra Part III.D.
219 See supra Part III.D.
220 See supra Part V.C; see also supra notes 95–98 and accompanying text.
221 The interviewee from Management Co. D stated that some parties invest in his firm’s funds as a favor to the large, powerful corporation that is the sole shareholder of the management company and the largest shareholder in the fund. See Interview D, supra note 201.
222 See supra text accompanying note 203 (discussing how securities firms “invest in venture capital funds to generate business for their underwriting services”).
fact, despite the costs of an apparently sub-optimal monitoring strategy, the fund managers of Taiwanese venture capital funds are nonetheless generally successful in soliciting non-capital contributions from their investors.

One strategy Taiwanese fund managers employ that may reduce the risk of investor shirking is to require each investor to subscribe to no less than five to ten percent of the total fund size.\textsuperscript{223} When an investor has a significant stake in the firm, she has a greater incentive to make non-capital contributions to the firm because she will then receive a greater proportion of any benefit the firm enjoys. Furthermore, a minimum investment requirement reduces the number of investors and thereby simplifies the structure of the board of directors.\textsuperscript{224}

Market realities, however, often compel fund managers to accept smaller investments as they near their capital-raising deadline. Although funds may have some free-riders because of these exceptions to the minimum investment rule, fund managers nonetheless generally endeavor to minimize the number of investors in their funds who do not own a relatively significant stake.

Once a fund has succeeded in raising capital from qualified investors, it becomes important to enlist their active participation in the decision-making process—otherwise the fund will not benefit from their expertise. Indeed, Taiwanese fund managers benefit from the experience and knowledge of their funds' investors by involving the board members, i.e., the investors, in the fund's decision-making.\textsuperscript{225}

As described above in Part V.B, the funds usually have a series of informal communications and/or informational meetings between the fund manager and the director-investors before the formal board meeting.\textsuperscript{226} During these informational meetings, directors with different areas of expertise ask the fund manager different questions, creating a beneficial exchange of ideas between them and the fund manager.\textsuperscript{227} The fund manager may also make special

\textsuperscript{223} See Interview A, supra note 182 (five percent); Interview B, supra note 170 (ten percent).

\textsuperscript{224} When there are too many investors, the composition of the board can be complicated. See Interview A, supra note 182.

\textsuperscript{225} See Lin, supra note 169, at 92 (reporting that one fund management firm values the ideas of the fund directors and encourages its managers to seek out the directors during the investment decision process).

\textsuperscript{226} See supra Part V.B; see also Lin, supra note 169, at 69, 74.

\textsuperscript{227} See Lin, supra note 169, at 92–93 (reporting that in informational meetings, the
efforts to obtain advice from investors with knowledge or experience that is especially relevant to the proposed investment.\textsuperscript{228} This kind of investor input into the decision-making process maximizes the benefits of the active-investor strategy, especially when the prospect of rejection forces the fund manager to incorporate investor input into her proposal.\textsuperscript{229}

Although investor participation in decision-making is important in maximizing the benefits of an active-investor fund, the investors will also be expected to make other, non-capital contributions in order to fully exploit the benefits of the active-investor strategy.\textsuperscript{230} Because the investors in Taiwanese funds participate in control of the fund through the board of directors, they arguably have a greater incentive to make non-capital contributions to the fund.\textsuperscript{231} In fact, investors in Taiwanese venture capital funds apparently make significant non-capital contributions to their funds.

Investors in Taiwanese venture capital funds act as a source of deal flow for their funds.\textsuperscript{232} It seems that on average, investors provide ten to fifteen percent of a fund’s investment opportunities.\textsuperscript{233} One fund has even reported that thirty percent of its investment opportunities had come from the investor-directors,\textsuperscript{234} although there are funds where the percentage is lower.\textsuperscript{235}

In addition to acting as a source of deal flow, a fund’s investors may also participate in due diligence on potential investments,\textsuperscript{236} provide the fund with valuable industry information,\textsuperscript{237} provide industry contacts for portfolio companies, or even enter into business transactions with portfolio companies.\textsuperscript{238}

directors representing investors from financial industries asked questions that were different from those asked by directors representing investors from manufacturing industries).

\textsuperscript{228} See Interview B, supra note 170.
\textsuperscript{229} See supra Part III.B (discussing how a right of approval maximizes the benefit of an active-investor strategy).
\textsuperscript{230} See supra Part III.B.
\textsuperscript{231} See supra Part III.B.
\textsuperscript{232} See Interview A, supra note 182; Interview B, supra note 170; Interview C, supra note 169.
\textsuperscript{233} See Lin, supra note 169, at 68, 102.
\textsuperscript{234} Id. at 87.
\textsuperscript{235} Id. at 82 (noting a fund where five percent of its investment opportunities came from investor-directors).
\textsuperscript{236} Id. at 92.
\textsuperscript{237} Id. at 87.
\textsuperscript{238} Id. at 68 (providing an example where investor contacts provided portfolio companies with access to customers).
Taiwan arguably resembles the hypothetical jurisdiction where organizational law influences the emergence of a market preference for active-investor venture capital funds. From 1983 to 2001, Taiwanese laws actually required venture capital funds to organize as corporations and Taiwan’s venture capital market did, in fact, develop an active-investor preference.

Of course, things are never that simple. Taiwanese corporate law was arguably flexible enough for creating passive-investor funds, which raises questions about the effect of organizational law on the market preference for active-investor funds. However, the general preference for simple contracts may have limited the actual ability of the parties to use innovative contract design to create a passive-investor fund, even though they had the legal ability to do so.

Finally, the influence of organizational law on the Taiwanese venture capital market is further obfuscated by market factors. It appears that market conditions in Taiwan have been less conducive to passive-investor funds in general, which would also contribute to the development of an active-investor market.

Although the Taiwanese venture capital market leaves us with no absolute conclusions about the effect of organizational law on a market preference for active-investor funds, it nonetheless informs our understanding of the transaction-cost strategies of active-investor funds. The most important of these strategies are: (1) assembling a group of qualified investors; and (2) encouraging these investors to make significant non-capital contributions to the fund by allowing them to participate in control and either sanctioning them for failing to make contributions and/or rewarding them when they do.

VI. CONCLUSION

This Article has demonstrated that organizational law can influence the development of a market preference for active- or passive-investor venture capital funds. The attractiveness of a particular management strategy in a venture capital market depends on whether the parties can efficiently structure their transactions to reduce the net costs of a particular strategy. Thus, the influence of organizational law on a market preference depends on whether it allows the parties to engage in efficient private
ordering for their preferred management strategy.

This Article has argued that when parties plan to pursue a passive-investor strategy for their venture capital fund, they are concerned not only with reducing the costs of potential fund manager opportunism, as existing literature has already discussed, but also with ensuring that the other investors will not participate in control of the fund’s business. With certain qualifications, the limited partnership allows the parties to reduce these costs most efficiently.

This Article has also argued that when the parties plan to pursue an active-investor strategy for their venture capital fund, they are concerned with maximizing the benefit of the investors’ non-capital contributions to the fund. With certain qualifications, the corporate form allows them to do this most efficiently.

If organizational law does not permit the participants in the venture capital market to address the transaction costs of their preferred management strategy efficiently, then the parties will choose among three suboptimal alternatives. First, when these organizational-law costs do not outweigh other benefits of the preferred management strategy, the parties will choose to bear the costs of the preferred strategy. When organizational-law costs are very high for the preferred management strategy, the parties will choose the second or third suboptimal alternative: they will either change to the less-preferred strategy or they will abandon or modify their transaction. Thus, high organizational-law costs will influence a market preference for a particular management strategy and result in suboptimal private ordering in the market.

Finally, this Article has argued that the fund manager will play an important role in reducing the transaction costs for both the active- and passive-investor strategies regardless of organizational form. In the passive-investor venture capital fund, the fund manager is an efficient enforcer of investor passivity. In the active-investor fund, the fund manager reduces the costs of finding qualified investors through coordinating and monitoring the non-capital contributions of investors.