THE WIDER IMPLICATIONS OF "IMPLICIT" CONTRACTS IN VENTURE CAPITAL PARTNERSHIPS

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Much of the high-technology industry in the United States has developed with the aid of venture capitalists willing to invest their money in incipient "startup" companies in exchange for a stake in those companies.[1] Venture capitalists raise capital from other investors, pool that money into venture capital funds, and invest those funds in startups.[2] Most venture capital funds are organized as limited partnerships with venture capitalists as general partners, and outside investors as limited partners.[3] Professor David Rosenberg explains that venture capital funds are structured as limited partnerships because this structure allows the partners maximum freedom of contract in creating the fund.[4] This freedom of contract allows the general partners to build an environment in which they can invest the fund's money freely.

Delaware law allows the parties in a limited partnership to contract around the fiduciary duties of care and loyalty,[5] and Professor Rosenberg claims that limited partnerships are "routinely" structured using Delaware law.[6] The effect of this is that the limited partners cannot sue the general partners for breaching these duties and have little recourse when the general partners act in a way that would normally be considered a breach of the duty of care or loyalty. Professor Rosenberg believes that when venture capital partnership agreements con-

1. *See* PAUL A. GOMPERS ET AL., THE VENTURE CAPITAL CYCLE 5 (1999).

2. *Id.*

3. *Id.* at 8.

4. David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 374.

5. Delaware law provides that "[a] partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement . . . " DEL. CODE ANN. tit. 6 § 17-1101(f) (2004).

6. *See* Rosenberg, *supra* note 4, at 370.

tract around the duties of care and loyalty, limited partners do not rely on the actual written partnership agreement to ensure the safety of their investments, but instead rely on a second, implicit contract that is reputation-based.[7] In a reputation-based contract, each party adheres to the contract in order to maintain a good reputation in the business community rather than out of a fear of legal repercussions.[8] When venture capital partnerships contract around the fiduciary duties, it is these implicit contracts—rather than the written partnership agreements—that underlie those partnerships.

This note will follow up on Professor Rosenberg's research in two ways. First, many limited partners in venture capital partnerships are large pension funds which are covered by the Employee Retirement Income Security Act of 1974 ("ERISA"). This note will analyze cases where ERISA pension fund managers agree to a reputation-based venture capital partnership that contracts around the fiduciary duties of care and loyalty, and will question whether those fund managers honoring their fiduciary duties to their own plan participants. The note will also examine whether, when such a reputation-based venture capital fund loses money, ERISA pension fund managers have a fiduciary duty to consider suing the general partners of the venture capital partnership rather than simply relying on the implicit reputation-based contract.

The note concludes that pension fund managers are acting within their fiduciary duties when they agree to reputation-based implicit contracts and, in the event a fund fails, choose to refrain from suing the general partners. In recent years there has been discussion about whether pension funds have a fiduciary duty to sue the companies in their investment portfolios when those companies have engaged in fraud.[9] But even if pension plan managers have a fiduciary duty to sue portfolio companies in cases of fraud, that does not mean that, in the absence of fraud, pension plan managers who are limited part-

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7. *See id.* at 396-97.

8. *Id.* Rosenberg also refers to this reputation-based contract as an "implicit" contract.

9. *See* John C. Coffee Jr., *"When Smoke Gets in Your Eyes": Myth and Reality About the Synthesis of Private Counsel and Public Client*, 51 DEPAUL L. REV. 241, 248 (2001).

ners have a duty to sue the general partners when a venture capital fund fails.

The note's second focus is whether the reputation-based contract model can successfully be applied to the relationship between a publicly-traded corporation and its shareholders. Some corporate boards would probably like to see Delaware make the fiduciary duties of care and loyalty default rules for public companies, because as long as their actions were not fraudulent, they could operate more freely in such a system. However, the freedom of contract that Delaware allows limited partnerships requires an ability to bargain among the parties to the partnership that does not exist between shareholders and the board of a publicly-traded corporation. The note concludes that the fundamental differences between venture capital limited partnerships and publicly traded corporations make the reputation-based contract model a poor fit for public companies.

I.
VENTURE CAPITAL FUNDS: PURPOSE AND STRUCTURE

Venture capital funds have been a driving force behind the growth of America's technology industry since the mid-twentieth century.[10] Over the last twenty years especially, venture capital has grown tremendously.[11] The economic troubles that began in 2001 dampened venture capitalists' enthusiasm in investment, but this slowdown has abated recently.[12] Although few think that venture capital investment will reach the level it was at in the late 1990s anytime soon, some have seen transactions such as Google's recent initial public offering ("IPO") as a sign that venture capital is to a large degree, "back in business."[13] Technology is an important part of the American economy, and there can be little doubt that by funding the companies that develop new technologies, venture cap-

10. GOMPERS ET AL., *supra* note 1, at 6.

11. *Id.*

12. *Venture Capital Investing Rises to $21 Billion in 2004 After Three Years of Decline*, PRNewswire (Jan. 24, 2005).

13. *See id.*; Lisa Baertlein, *Google IPO to Help Venture Capital, No Boom Seen*, REUTERS (Apr. 27, 2004), *available at* http://www.forbes.com/home/newswire/2004/04/27/rtr1348271.html.

italists will continue to play a crucial role in America's economy for the foreseeable future.

Venture capital funds invest in privately held companies, often at a very early stage in a company's life. Many of these fledgling companies have no track record of success and limited assets.[14] Often these companies are based on little more than a promising idea and a talented cadre of employees. Without proven revenues, these companies are unable to avail themselves of traditional capital markets.[15] However, a source of capital is necessary for start-up companies because developing new technology is quite expensive. More often than not, this capital comes from venture funds.[16] Every two to five years, venture capitalists open a fund and raise money from outside investors to put into the fund.[17] These funds typically have a 10-12 year lifespan and money from the funds is invested in private start-up companies by the venture capitalists.[18] In exchange for their investment, venture capitalists often take a stake in the company and it is common for venture capitalists to sit on the boards of the companies in which they invest.[19] Since the companies in which they invest are often new, venture capitalists will at times be active in the management of the company, bringing their own experience to bear on the incipient company's development.[20] Venture capital is therefore a more "hands-on" type of investment than other, more passive investment strategies such as mutual funds. A venture capitalist's goal in investing in a company is to get a good return on her fund's investment, sometimes through an "exit strategy," i.e. the sale or IPO of the company.[21]

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14. *See* GOMPERS ET AL., *supra* note 1, at 5.

15. *Id.*

16. *Id.* at 5.

17. *Id.*

18. *Id.*

19. *Id.*

20. Venture capitalists are often former technology executives. *See* Dawn Kawamoto, *Why former Oracle president joined Kleiner Perkins*, CNET NEWS.COM (Aug. 23, 2000), *available at* http://news.com.com/2100-1001-244855.html?legacy=cnet.

21. GOMPERS ET AL., *supra* note 1, at 6.

Venture capital investing is laden with risk but the rewards can be enormous.[22] If history is any guide, the majority of a venture capitalists' investments will ultimately prove unsuccessful, but the benefits of even a single successful IPO will usually more than make up for the losses incurred through failed investments.[23] It is very similar to drilling oil wells: the well that strikes oil more than pays for the expense of drilling unsuccessful wells. This potential for reward drives venture capitalists to open new funds, and motivates investors to put money into those funds.[24]

During the early years of venture capital technology investment, venture capital funds were structured as publicly traded closed-end funds.[25] The first limited partnership venture capital fund was formed by Draper, Gaither and Anderson in 1958.[26] However during the 1960s and 1970s, most venture capital funds continued to follow the closed-end fund model.[27] Since the 1980s, however, venture funds have commonly been structured as limited partnerships.[28] A limited partnership is composed of general and limited partners.[29] In venture capital funds, the general partners are the venture capitalists themselves: the people whose job it is to build and manage the funds and invest the funds' money.[30] The limited partners are those who invest in the funds.[31] Typically almost all of a fund's money comes from the limited partners.[32] The general partners put in very little of their own money but collect a management fee and get a significant "carry" or share of

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22. *See, e.g.*, David Rosenberg, *The Two "Cycles" of Venture Capital*, 28 J. CORP. L. 419, 420 (2003) (reporting average venture capital returns of 163% in 1999).

23. *See* GOMPERS ET AL., *supra* note 1, at 6.

24. *Id.* at 5.

25. A closed-end fund is a "mutual (fund) whose shares must be sold to other investors rather than redeemed from the issuing firm." *Id.* at 8. The first modern venture capital fund, American Research and Development, formed in 1946, was structured as a closed-end fund.

26. *Id.*

27. *Id.*

28. *Id.*

29. Rosenberg, *supra* note 4, at 366.

30. *Id.*

31. *Id.*

32. *Id.*

the fund's profits which can be as high as 20%.[33] Limited partners are usually risk-tolerant investors with a large amount of capital to invest.[34] Wealthy families and large institutional investors are typical limited partners in venture capital funds.[35] In the United States, pension funds have become the most common investor in venture capital funds.[36]

II. GENERAL PARTNERS' LEGAL OBLIGATIONS TO LIMITED PARTNERS

When a venture capital fund fails and the general partners did not engage in fraudulent behavior, limited partners have little legal recourse against the general partners. If limited partners attempt to exercise control over the partnership, they risk losing their status as limited partners and the corresponding beneficial flow-through taxation status.[37] Therefore, limited partners must rely on the partnership contract itself for any legal protections.[38] Delaware's Revised Uniform Limited Partnership Act ("DRULPA"), imposes a fiduciary duty of care and loyalty on general partners in a limited partnership.[39] General partners are assumed to have acted on an informed basis and in the belief that their actions were in the best interests of the partnership.[40] In order to rebut this presumption, a plaintiff must show that the general partners stood on both sides of the transaction or derived a personal benefit from the transaction along the lines of self-dealing.[41] However, DRULPA also allows the parties in a limited partnership to contract around virtually all fiduciary duties in the partnership agreement, thereby relieving general partners of the fiduciary responsibilities outlined in DRULPA.[42]

The majority of venture capital limited partnership agreements contract around DRULPA's default fiduciary duties and

33. *Id.* at 364 n.3.
34. *Id.* at 366.
35. *Id.*
36. *See* GOMPERS, ET AL., *supra* note 1, at 7.
37. *See* Rosenberg, *supra* note 4, at 384.
38. *Id.*
39. *Id.* at 388.
40. *Id.* at 389.
41. *Id.* at 389-90.
42. *Id.* at 388; DEL. CODE ANN. tit. 6 § 17-1101(f) (2004).

construct fiduciary duties that fit the particular partnership being formed.[43] Under these agreements, general partners have nearly total control over how the fund is used: what investments are chosen, how much money is put into each investment, the funding schedule, and oversight over the management of each company. These partnership agreements rarely result in litigation.[44] Even if the default standards are in place (that is, DRULPA's business judgment presumption is not contracted around) there are no major cases where limited partners have successfully sued general partners for breach of their fiduciary duties.[45] This could indicate that even when the default fiduciary duties of care and loyalty are not contracted around, the implicit contract—rather than the written document—governs the partnership.

One recent case illustrates the difficulty limited partners face in successfully suing general partners. The fund involved was a private equity rather than venture capital fund, but since the fund was an investment vehicle made up of general and limited partners, the same principles apply. The State of Connecticut sued Forstmann Little & Co. after incurring substantial losses on an investment in one of the company's funds.[46] The fund in question was structured as a limited partnership, with Connecticut and other investors as limited partners and Forstmann Little's partners as general partners.[47] The fund contract specified that no more that 40% of the fund was to be used in investments above a certain threshold of risk.[48] Connecticut's Attorney General claimed that, by investing most of the fund's money in XO Communications and McCloud Communications, Forstmann Little had invested more than 40% of the fund's money in an investment that was far riskier than allowed.[49] The jury found for Connecticut because it decided

43. Rosenberg, *supra* note 4, at 392.

44. *Id.*

45. Rosenberg, *supra* note 24, at 431.

46. *See generally* Rebecca Silberstein, *The Aftermath of Conn. V. Fortsmann Little: Lessons from Connecticut State Court* (Aug. 26, 2004), *available at* http://www.altassets.com/casefor/countries/2004/nz5362.php.

47. *Bartlit Beck wins jury victory for Forstmann Little & Co. in Case Closely Watched by Wall Street* (July 12, 2004), *available at* http://www.bartlit-beck.com/articles/detail.asp?whichid=935507192004.

48. *See* Silberstein, *supra* note 46, at 2.

49. *Id.*

that Forstmann Little had been grossly negligent in putting more than 40% of the fund's money in risky investments. However, the jury awarded no damages because it found that Connecticut knew about and acquiesced to the investment strategy.[50] Both sides declared victory and Connecticut's State Treasurer said it was the first time a limited partner had successfully sued a general partner.[51] Yet the fact that no damages were awarded makes the verdict rather hollow.

The jury's reluctance to award damages reflects a common trend in lawsuits where limited partners sue general partners of private equity or venture capital funds: unless there has been a blatant and fraudulent breach of contract in which the general partner has acted without the limited partners' consent, judges and juries have difficulty buying into the claim that sophisticated parties like institutional investors did not understand the risk inherent in venture capital and private equity investments.[52]

III. THE ROLE OF REPUTATION

If one may contract around default fiduciary rules when forming limited partnerships under Delaware law, what guarantees besides those specifically outlined in the partnership agreement do limited partners have that their investments will be safe in the hands of the general partners? On one hand, there is the general partners' natural inclination to manage the fund well to generate profits for themselves.[53] Rosenberg has suggested that reputation also provides a guarantee of good fund management.[54] General partners have an incentive to manage a fund responsibly because their reputation in the investment community will suffer if they fail to do so.[55] The status of a particular venture capital fund is largely driven by

50. *Id.*

51. Press Release, Connecticut Attorney General's Office, *Forstmann Little Agrees to $15 Million Settlement of Lawsuit Filed by Connecticut Pension Fund* (Sept. 20, 2004), *available at* http://www.cslib.org/attygenl/press/2004/other/Forstman_Little_092004.htm. Forstmann Little agreed to the settlement in order to resolve outstanding claims after the jury verdict. *See id.*

52. *See* Rosenberg, *supra* note 24, at 430.

53. Rosenberg, *supra* note 4, at 365.

54. *Id.*

55. *Id.*

the personal qualifications of the individual venture capitalists. General partners' reputations and standing in the investment community are based on their own expertise and ability. Successful venture capitalists are known for their abilities to pick good companies as investment opportunities, nurture such companies, and generate large returns on their investments through IPOs or sales of these companies.[56] A good venture capitalist possesses a broad range of skills that are acquired through a great deal of firsthand experience in their industry and it often takes years for a venture capitalist to build a strong reputation. This reputation for success is a venture capitalist's lifeblood, and the general partners' desire to maintain this reputation ends up being much more effective than formal contracts at ensuring the well-being of limited partners' investments.[57]

Rosenberg suggests that reputation also affects the behavior of the limited partners.[58] Venture capital funds represent attractive investments with potentially large rewards, and limited partners in any one particular fund will presumably be interested in investing in other funds.[59] If a limited partner enters into a legal battle with the general partners over a particular fund's performance, chances are not good that those general partners will want to raise a fund involving that particular limited partner again. Furthermore, that limited partner may get a reputation for being difficult to work with and may be shut out of other venture capitalists' funds.[60] Therefore, limited partners have an incentive to behave well and not get a reputation for being difficult.

There are two strong reasons driving a lack of litigation in the world of venture capital limited partnerships. First, limited partners who are contemplating a suit may have trouble finding grounds on which to sue. Most partnership agree-

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56. GOMPERS, ET AL., *supra* note 1, at 5.

57. Rosenberg, *supra* note 4, at 398.

58. *Id.* at 394.

59. *Id.*

60. *See* Dan Primak, *The Case Begins: Conn. vs. Forstmann* (June 7, 2004), *available at* http://www.ventureeconomics.com/pew/protected/articles/fundnews/1070549978471.html (discussing the Forstmann Little litigation and noting that "Connecticut has its own fiduciary responsibility to worry about, as its pension system could be viewed as litigation-happy, thus making it an unattractive (limited partner) in future funds.").

ments contract around default fiduciary duties of care and loyalty and Delaware courts tend to require *scienter* with respect to specific breaches of contract. Second, limited partners will be reluctant to risk their own reputation through litigation.

DRULPA's flexibility allows parties to "align their interests" and write partnership agreements that reflect the circumstances of the particular fund.[61] This allows the general partners to invest the fund's money in ways they believe to be most effective in an attempt to generate the highest returns possible. Limited partners are interested in an investment that has a strong probability of generating high returns. General partners, who typically put up one percent or less of the capital in a VC fund[62], make their money through a portion of the net profits, known as a "carried interest."[63] Typically the general partners' share of the profits is twenty percent.[64] Limited partners seem quite willing to give up all control over their investments and lock themselves into a 10-12 year partnership agreement because of the promise of high returns. General partners are interested in getting their twenty percent of the profits and maintaining reputations as savvy investors. The two parties interests' are aligned when limited partners give general partners maximum freedom to invest in exchange for the insurance that the general partners will not get paid and may put their reputations as good venture capital fund managers at risk if they do not invest wisely. Although venture funds carry a high level of risk, limited partners, such as pension funds, are able to tolerate this risk because they maintain a diverse pool of investments and they rely on the general partners' carried interest and desire to maintain good reputations to ensure that a venture fund's capital is invested intelligently.[65]

IV. ERISA FUNDS AS LIMITED PARTNERS

Pension funds are the most common limited partner in American venture capital funds and it is worth exploring their

61. Rosenberg, *supra* note 4, at 398.
62. *Id.* at 366.
63. *See* GOMPERS ET AL., *supra* note 1, at 20.
64. Rosenberg, *supra* note 4, at 391.
65. *Id.* at 398.

relationship to venture capital more closely. Pension funds are governed by ERISA.[66] ERISA was a response to Congressional concerns that pension funds—which hold many Americans' retirement money—were not adequately regulated.[67] Congress intended to:

> protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts.[68]

Since pension funds are the largest single investor in venture capital funds in the United States[69], ERISA has an indirect impact on American venture capital.

ERISA, which is based on the common law of trusts, states that pension fund managers are subject to a prudent investor rule.[70] Fiduciaries must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in his conduct of an enterprise of like manner of a like character and with like aims."[71] For the first five years after ERISA went into effect, ERISA's prudent investor rule barred pension funds and other fiduciaries regulated under ERISA from investing in venture capital funds.[72] In 1979, however, the Department of Labor—which is responsible for administering ERISA—promulgated a ruling stating that the prudent investor rule did not bar fiduciaries regulated by ERISA from investing in venture capital funds as long as the fiduciaries maintained a sufficiently diverse pool of investments.[73]

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66. 29 U.S.C. § 1001 (2005).
67. *Id.*
68. *Id.*
69. *See* GOMPERS ET AL., *supra* note 1, at 7.
70. 29 U.S.C. § 1104 (2005).
71. *Id.*
72. GOMPERS ET AL., *supra* note 1, at 7.
73. *See id.;* Haksoo Ko & Hyun Young Shin, *Venture Capital in Korea? Special Law to Promote Venture Capital Companies*, 15 AM. U. INT'L L. REV. 457, 461 (1999).

This decision paved the way for pension funds to pour significant amounts of money into venture capital funds, and likely contributed to the growth of venture capital in the 1980s.[74] ERISA's prudent person standard has been interpreted as requiring pension funds "(1) to employ proper methods to investigate, evaluate and structure the investment; (2) to act in a manner as would others who have a capacity and familiarity with such matters; and (3) to exercise independent judgment when making investment decisions."[75] This interpretation of ERISA's fiduciary responsibilities shows why pension fund managers were reluctant to invest in venture capital funds prior to the Department of Labor's ruling. By turning over money to a fund that gives limited partners no control over how the fund is invested, the limited partners could reasonably be accused of violating the first and third elements of the courts' interpretation of ERISA's fiduciary responsibilities.[76] Now that pension funds are able to invest in venture capital funds, it seems that ERISA's primary safeguard against a pension fund's unsound investment decisions is the "diverse investment" requirement.[77] This rule states that as long as an investment does not put an entire pension fund portfolio at risk, pension fund managers are free to invest in venture capital funds that carry substantial risk.[78]

V.
CONTRACTING AROUND FIDUCIARY DUTIES IN VENTURE PARTNERSHIPS IS COMPATIBLE WITH ERISA FUND MANAGERS' FIDUCIARY DUTIES

Given DRULPA, one may be tempted to question the wisdom of the Department of Labor's ruling. At first blush it seems to allow ERISA fund managers to disregard their fiduciary duties to shareholders in their plans when investing in venture capital funds governed under the law. Professor Rosenberg's explanation of the reputation-based venture capital

74. In 1978, 15% of the money in venture funds in the United States came from pension funds. In 1988, 46% of the money in American venture funds came from pension funds. GOMPERS ET AL., *supra* note 1, at 7.

75. Ulico Casualty Co. v. Clover Capital Management, Inc., 335 F. Supp. 2d 340 (N.D.N.Y. 2004).

76. *Id.*

77. *See* Ko, *supra* note 76, at n.9.

78. *Id.*

partnership provides a compelling reason why entering into reputation-based venture capital contracts is compatible with the fiduciary duties mandated by ERISA.[79]

We can best see why ERISA now permits investment in venture capital partnerships by looking more closely at the two elements that raise the most questions about ERISA's compatibility with venture capital limited partnerships—the mandates that a fund plan manager must "employ proper methods to investigate, evaluate and structure the investment" and "exercise independent judgment when making investment decisions."[80] The "proper methods" used to investigate, evaluate and structure venture capital investments are inquiries into the reputations of the general partners. Potential limited partners considering investing in a venture capital fund will look at the past performance of the general partners of the fund, find out the rate of return on past investments by those partners, inquire into how those general partners have treated limited partners in the past, and make sure that those general partners have an expert understanding of whatever industry the fund will invest in.[81] These inquiries constitute an investigation of the ERISA fund's potential investment in the venture capital limited partnership and are similar to the investigations an ERISA fund manager might make into a public corporation's management and performance when deciding whether to buy stock in that corporation.

The ERISA fund manager's "independent judgment" is also "exercised" when making these initial inquiries into a venture capitalist's reputation.[82] Again, this is not so different than any other investment a pension plan manager might make. When a pension fund manager buys stock, she exercises independent judgment in making the decision to buy. Once the stock is purchased, however, she must put a certain amount of trust in the corporation's management to look after shareholders' interests and manage the corporation wisely.

By allowing ERISA fund managers to acquiesce to a partnership contract that eliminates the fiduciary duties of care and loyalty, the Department of Labor is implicitly acknowledg-

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79. Rosenberg, *supra* note 4, at 398.
80. *See Ulico Casualty*, 335 F. Supp. 2d at 340.
81. *See* Rosenberg, *supra* note 4, at 366-67.
82. *Id.*

ing that ERISA fund managers do not need those protections.[83] ERISA fund managers are sophisticated investors and understand how to read and write contracts. These fund managers will generally only enter into contracts that are favorable to their interests. Even though the written partnership contracts do not give limited partners much legal leverage over the general partners if things go astray with the venture capital fund, limited partners will be protected from breaches of care and loyalty by the implicit reputation-based contract that is based on general partners' interests in maintaining a good reputation in the venture capital community.[84] Large institutional investors who invest as limited partners in venture capital funds and acquiesce to a contract that excludes any obligation on the part of the general partners to exercise care and loyalty are not disregarding their fiduciary duties to the shareholders in their own funds. Instead, they are relying on a different set of protections to ensure that general partners will act with the best interests of the limited partners in mind.[85]

VI.
IS THERE A FIDUCIARY DUTY TO LITIGATE?

Although entering into reputation-based venture capital contracts may not violate a fund manager's fiduciary duties, the question remains of how the manager of an ERISA pension fund should respond when the fund loses money. What response is most in line with the fund manager's fiduciary duties to her plan participants? With the recent fiascos at corporations like Enron and Worldcom, litigation has become a popular shareholder strategy.[86] Some observers have even suggested that fund managers have a fiduciary duty to their own shareholders to consider engaging in securities litiga-

83. *Id.* at 369. DRULPA was passed in 1992 and the Department of Labor's amendment was passed in 1979. *See* GOMPERS ET AL., *supra* note 1, at 7. The fact that the Department of Labor has not reacted to DRULPA's transformation of fiduciary duties into default rules indicates that the Department regards ERISA pension funds participation in venture capital funds governed by DRULPA as within those pension funds' fiduciary duties.

84. *See* Rosenberg, *supra* note 4, at 398.

85. *Id.*

86. David Wasick & Joseph J. Tabacco Jr., *Navigating the Waters of Securities Litigation*, 12 NEV. LAW. 18 (2004).

tion.[87] Rosenberg has observed that there is limited litigation resulting from venture capital losses.[88] Part of the implicit venture capital contract seems to be an agreement on the part of the limited partners to refrain from litigation when the fund loses money. However, in light of the recent suggestions that funds have a duty to engage in securities litigation and Connecticut's lawsuit against Forstmann Little, one might ask whether large institutional investors regulated by ERISA who are limited partners in venture funds have a fiduciary duty to at least consider responding to poor venture capital fund performance with litigation.

One reason why litigation is not a good strategy was mentioned above. When sophisticated, fully-informed parties contract around the duties of care and loyalty and there is no fraudulent behavior on the part of the general partners, it is very difficult for limited partners to sue general partners over a fund's poor performance.[89] Many limited partners likely refrain from suing general partners because they are aware of this difficulty. In a sense, they took a chance and lost. In the future they may wish to invest with a different group of venture capitalists or eschew venture capital altogether, but unless the general partners committed fraud, limited partners will usually chalk any current losses up to bad luck.

A deeper problem with the widespread use of litigation by limited partners to recover lost investments is that such litigation threatens to undermine the implicit contract model that underlies most venture capital partnerships under Delaware law.[90] Rosenberg notes that an important part of the implicit contract is the limited partners' pledge not to sue the general partners in the absence of fraud.[91] There are two reasons for this pledge. As mentioned above, the reputational constraints on behavior work both ways.[92] The venture capitalists want to develop and maintain reputations as effective general partners and the investors want to develop and maintain reputations as limited partners who would be welcome participants in future

87. *Id.*

88. Rosenberg, *supra* note 24, at 431.

89. *Id.* at 432-33.

90. *Id.* at 439-40.

91. *Id.* at 440.

92. Rosenberg, *supra* note 4, at 394.

venture funds.[93] Limited partners who develop a reputation for being litigious may have difficulty investing in other venture capital funds.[94]

Furthermore, limited partners may find that the financial rewards that can typically come from a venture capital partnership will be lessened by the threat of a lawsuit.[95] General partners will put less stock in the implicit contracts and will be less willing to take potentially rewarding risks with their investments.[96] If limited partners honor the implicit pledge not to litigate and the venture capital fund is not profitable, the general partners face the double threat of not getting paid and possibly developing reputations as poor fund managers. If, however, the limited partners fail to honor their implicit promise not to sue, the general partners face the third risk of possible legal liability. With the specter of a lawsuit looming in case of failure, general partners who decide to make bold investments will likely demand a larger share of any potential profits as compensation for the risk of exposure to litigation. Venture capital funds will either be less profitable because the general partners will be less willing to take risks, or the funds' profit levels will stay the same and general partners will demand a larger share. Either way, the limited partners face lower returns if the limited partners' implicit pledge to refrain from litigation is not honored.

These two problems with litigation in venture capital partnerships, the difficulty of convincing a court that a contract has been breached and the fact that litigation could undermine the implicit reputation-based contract, show why limited partners who are ERISA fund managers should not feel compelled by their fiduciary duties as prudent investors to sue general partners of failed funds absent fraudulent behavior on the general partners' part. In the long run, litigation would weaken the reputation-based contract that has allowed venture capitalists the freedom to operate and generate large returns for limited partnerships.[97] The Department of Labor's 1979 decision to allow ERISA plans to invest in venture capital funds

93. *Id.*

94. *See id.*

95. Rosenberg, *supra* note 24, at 439-40.

96. *See id.*

97. *See* Rosenberg, *supra* note 24, at 440.

was an acknowledgment that ERISA's prudent investor rule is compatible with the operating structure of venture capital limited partnerships.[98] The fact that the Department of Labor has not prohibited ERISA plans from investing in venture funds structured under DRULPA indicates that the Department does not object to the implicit reputation-based contract that results from DRULPA. Professor Rosenberg has shown that this contract includes the implicit pledge of the limited partners to refrain from litigation and instead rely on the reputational constraints in the implicit contract.[99] Once we have acknowledged that ERISA fund managers may enter into implicit contracts, we must accept that those same fund managers would not be breaching their prudent investor duties by adhering to those implicit contracts and avoiding litigation in favor of reputational constraints.

VII.
SHOULD REPUTATION PLAY A LARGER ROLE IN OTHER CONTEXTS?

We have seen the venture capital method of contracting around default rules, eschewing breach of contract litigation over disappointing returns, and relying on reputation as the main guarantee of good results.[100] If we accept the notion that, in the long run, this is the best way to build a successful system of venture capital, we should ask whether the DRULPA model of allowing partners in a limited partnership to contract around default fiduciary duties might be applied in other situations like director-shareholder relations.

DRULPA, which treats fiduciary duties as default rules and allows limited partnership venture capital funds to contract around those fiduciary duties, is essentially a legislative embodiment of "contractarian" theory.[101] Contractarian theorists see the legal structures around which businesses are organized as a set of contracts creating relationships among parties.[102] For instance, Tamar Frankel writes that contractarians

98. *See* Ko, *supra* note 76, at 461.
99. Rosenberg, *supra* note 24, at 440.
100. Rosenberg, *supra* note 4, at 398.
101. *See id.* at 369.
102. Tamar Frankel, *Fiduciary Duties As Default Rules*, 74 OR. L. REV. 1209 (1995).

"define corporations as criss-crossing contracts among the different actors, including shareholders and management."[103] Along the same lines, contractarians see partnerships as contracts, and speak of partnerships as if they were little more than one or more contracts binding the general and limited partners.[104]

Many contractarians are opposed to mandatory fiduciary duties of care and loyalty but differ on what, if any, role these duties should play in a contract-driven world.[105] Some believe that the traditional fiduciary duties of care and loyalty should be done away with altogether.[106] Others feel that the duties of care and loyalty should be transformed into default rules that the parties to a contract may "contract around."[107] Since it keeps the fiduciary duties of care and loyalty as default rules that parties in a venture capital partnership may contract around, DRULPA falls into the second category.

If we agree that the DRULPA model works well in venture capital limited partnerships, we should ask why the model should not be used elsewhere. For instance, why not make the fiduciary duties of care and loyalty default rules in the corporate context? A corporation that wished to eliminate the duties of care and loyalty would expressly eliminate those duties in their charter. Shareholders would rely on the reputations of the directors and managers in making their investment decisions.

Although reputation plays a valuable role in venture capital limited partnerships, it does not necessarily follow that reputation-based standards would work so easily in other contexts such as public corporations. The venture capital community is much different than the world of Wall Street. The pool of potential limited partners in a venture capital fund consists mainly of fairly sophisticated investors such as large mutual funds or pension funds.[108] This is a rather small group and it is more than likely that many potential limited partners know each other or have mutual acquaintances. These relationships

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103. *Id.*

104. *Id.* at 1209-10.

105. *See id.* at 1211.

106. *Id.*

107. *Id.*

108. *See* GOMPERS ET AL., *supra* note 1, at 7.

make it much easier to gather information on general partners' reputations. If a general partner's reputation takes a dramatic fall, word will likely spread quickly through the informal community of venture capital investors.

In contrast to the pool of potential limited partners in venture capital partnerships, the pool of potential investors in a company's stock is vast. Anyone with enough capital to invest can buy stock in a company. The kind of communication possible among investors in venture capital funds is not possible among investors in the stock market as a whole.[109] An investor who is thinking of buying some shares of a company and wants to know about the reputation of the company's management must sift through a great deal of information to get a real sense of what the managers are like.

Furthermore, the community of potential limited partners in venture capital funds is relatively sophisticated compared to the average individual investing in the stock market. Not only can they typically get information on a general partner's reputation, but they can also analyze that information in a meaningful way. In contrast, many individuals who invest in the stock market do not have the expertise to make an educated decision on the competency of the managers of stocks they are considering buying, even when presented with information on the managers' reputations.[110] Of course, large institutional investors such as pension funds and mutual funds are major holders of stock in the United States, and these investors do have significant expertise when it comes to evaluating information about their investments.[111] There are also many individual investors, however, who base their investment decisions on limited information and are relatively unsophisticated when compared to institutional investors.

Another crucial distinction between venture funds and public corporations is the fact that shareholders' and management's interests are not necessarily aligned in a public company the way the general and limited partners' interests are aligned in a venture capital partnership. Anyone who reads

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109. Peter Talosig, *Regulation FD–Fairly Disruptive? An Increase In Capital Market Efficiency*, 9 FORDHAM J. CORP. & FIN. L. 637, 702 (2004).

110. *See id.*

111. Douglas M. Branson, *Corporate Governance "Reform" and the New Corporate Social Responsibility*, 62 U. PITT. L. REV. 605, 630 (2001).

the business section of a newspaper or magazine with any regularity has surely seen reports of companies that raise upper management's pay as share prices fall.[112] In many corporations, management compensation has little to do with value created for shareholders. As noted above, the general partners in a venture capital fund (for our purposes, the equivalent of management at a corporation) are not paid unless the fund is successful.[113] The disconnect between shareholder value and management compensation that often exists in public corporations does not exist in venture capital limited partnerships.

This difference in size and sophistication between the pool of potential investors in the venture capital community and the pool of potential investors in publicly traded corporations, as well as the lack of a connection between shareholder value and executive compensation explains why investors in publicly-traded corporations need the protection of mandatory fiduciary duties of care and loyalty. It boils down to an ability to bargain. Frankel notes that in order to bargain around fiduciary rules and still have a reasonable chance of obtaining a result that is fair to all parties involved, some criteria need to be met.[114] There must be notice of the proposed change in the default fiduciary rules, full information about the bargain must be given, the bargain must be specific, consent to the bargain must be clear, and the bargain must be fair.[115] When the manager of a large pension fund who is considering becoming a limited partner in a venture capital fund agrees to a contract that creates a fund and binds the general and limited partners in the fund, each of these criteria can be met. The pension fund manager is experienced enough with investments and contracts to understand the proposed elimination of the default rules, savvy enough to demand full information about the new contract and make inquiries when the information is unclear, and capable of striking a fair bargain in exchange for her stake as a limited partner. Most impor-

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112. *See, e.g., We're (Still) In the Money*, THE ECONOMIST, *available at* http://www.economist.com/globalExecutive/remuneration/displayStory.cfm?story_id=1760661 (last accessed May 12, 2005).

113. *See supra* note 35 and accompanying text. *See also* Rosenberg, *supra* note 24, at 424.

114. *See* Frankel, *supra* note 102, at 1234.

115. *Id.*

tantly, a potential limited partner has a chance to bargain in the first place. As one of a small number of limited partners in a venture fund, a potential limited partner understands the proposed contract and has the ability to craft a contract that suits her needs as well as the needs of the general partners.[116]

In contrast, if a corporation were able to waive the fiduciary rules of care and loyalty, it would be unlikely that shareholders would be in a good position to bargain over such a waiver. Many shareholders simply do not have the expertise to understand what the fiduciary rules of care and loyalty are, let alone bargain around them.[117] The duties of care and loyalty give investors a certain level of protection, and any attempt to contract around those rules would, more likely than not, be a one-sided and ultimately unfair attempt by the directors of a corporation to remove certain constraints on directors' behavior without giving the shareholders anything else in return. Shareholders' inability to strike a meaningful bargain in contracting around the default rules of care and loyalty is an important reason why the DRULPA model of default fiduciary rules should not be applied to publicly traded corporations.

VIII.
Conclusion

DRULPA allows limited and general partners in a venture capital fund to contract around the fiduciary duties of care and loyalty and craft an agreement that gives the general partners a great deal of freedom when making investment decisions. In return, limited partners get the benefit of the traditionally high returns that venture capital funds generate. Rather than the written contract—which is relatively unenforceable in court—a type of implicit reputation-based contract binds the general and limited partners in a venture capital fund. The reputational constraints in this implicit contract are strong enough that pension funds covered under ERISA can enter into partnerships as limited partners—in which the

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116. Admittedly, venture capital partnership agreements heavily favor the general partners. The main point is that limited partners fully understand the contract they are entering and have some (perhaps limited) opportunity to tailor that contract to fit their needs. At the end of the day, the limited partners know what they are getting involved in and think it is a fair deal.

117. *See* Frankel, *supra* note 102, at 1243.

general partners' duties of care and loyalty are waived—and not run afoul of their own fiduciary duties to their own investors. Furthermore, given the limited chance of success in a lawsuit against a general partner and the implicit contract's reliance on reputation rather than litigation, ERISA pension fund managers are justified in choosing not to sue the general partners when a venture capital fund loses money.

Despite its success in the world of venture capital, the DRULPA model does not translate well into the context of a publicly-held corporation. The major difference is the sophistication of the investors involved and their ability to bargain around the fiduciary duties of care and loyalty. Many investors in publicly-held companies are simply not capable of making an informed decision on whether to contract around the fiduciary duties. It makes sense, therefore, to keep mandatory fiduciary duties in place for publicly-traded Delaware corporations and ensure that those investors have some level of protection.