can think of investors as having invested fully at the onset and also retaining a put option. By defaulting, investors exercise the put, in effect selling their interest (or part of their interest) back to the fund at a strike price that is related to the default penalty specified in a partnership agreement.[2] Thus, we can use the severity of default penalties to measure the price tag attached to the exercise of the walkaway option. Likewise, partnership agreements specify a minimum *term* of the walkaway option, which can be derived from the provisions specifying what percentage of total commitments the VC may call annually.

An investor walkaway option becomes more valuable (a) when its term increases (that is, when the percentage limit on annual callable capital declines); (b) when the strike price increases (that is, when the default penalty declines); and (c) when uncertainty about VC quality increases (that is, when a VC is of lesser quality or when his performance is otherwise less certain).

The governance benefits of the walkaway option come at a cost in liquidity. The presence of both governance and liquidity considerations explains why we do not see either funds where investor walkaways go completely unpunished or funds where investor walkaways are not permitted at all.

This Article documents and examines this governance-liquidity tradeoff. I analyze the provisions of venture capital limited partnership agreements that determine the strength of the investor walkaway option—default penalties and minimum time periods before the fund is fully invested. I assess whether, across venture funds, these two elements of the investor put option vary in economically sensible ways. One can think of governance concerns and liquidity needs as two competing factors that can affect walkaway rights. If governance considerations are the dominant factor in determining the strength of investor walkaway rights, default penalties should be lower and option terms longer when investors' need to oversee venture capitalists' investment decisions is high—that is

replace a defaulter.

These competing governance and liquidity hypotheses generate

A final "boilerplate" hypothesis is that default penalties and option terms are unimportant legal boilerplate. If so, these terms should vary randomly across funds, and will likely reflect which law firm the venture capitalist happens to have chosen.

To test these hypotheses, the Article studies partnership agreements of 38 venture capital funds raised by 18 U.S.-based venture capital firms between 1987 and 2003. I code the severity of default penalties on a scale from 1 (least severe) to 10 (most severe). I define the term of a walkaway option as equal to 100/(maximum percent of capital commitment that VCs can call per year). I then ask whether the severity of the default penalty and the term of the walkaway option are predicted by factors that proxy for the fund's need for governance and liquidity: VC quality (fund size, fund number, and overall level of VC compensation); riskiness of VC compensation (the relative and absolute size of carry and management fee); outside world conditions (the year when the fund was raised and the hotness of the venture capital market during that "vintage" year); alternative ways to address liquidity concerns (the fund's ability to borrow); and alternative performance incentives employed by the fund (minimum mandatory coinvestment by the VC in the fund).

I find significant, albeit incomplete, support for the governance-based hypotheses. Controlling for other things, funds where VCs receive higher total compensation (that is, funds whose VCs are perceived by the market as being of higher quality) and funds where VC compensation is riskier make walkaway more difficult by employing shorter option terms. Also controlling for other things, larger funds (typically run by better VCs) are more likely to restrict walkaways by using higher default penalties. On the whole, funds that confront lesser agency problems give investors a weaker governance tool in the form of walkaway rights.

The liquidity hypothesis receives support only from areas in which the governance and liquidity explanations generate the same predictions: a positive relationship between the hotness of the venture capital markets and the strength of walkaway rights.

The investor-reputation hypothesis and the information-costs hypothesis receive no support in my data. Larger funds, which likely have higher-quality, reputation conscious investors, employ *higher* [illegible] *is inconsistent with the governan*

sensible choice in the corporate context. An interesting question for future research is which corporate governance or market factors make the use of put rights in corporations relatively unattractive.

A caveat: my sample size is small and not random. Partnership agreements are private, carefully guarded documents. My sample contains only agreements that were provided to me by venture capitalists and investors.

This Article proceeds as follows. In Part II, I discuss the evidence on investor defaults. Is the walkaway option long enough to play a real governance role? Do investors actually exercise walkaway rights? Are investor defaults triggered by governance considerations? Do defaults threaten funds' liquidity? Do industry participants view default penalties as a useful tool to manage investor defaults?

Part III discusses the installment system of capital contributions used in the venture capital industry, as well as my coding of default penalties and option terms.

Part IV frames my hypothesis that the optimal level of capital stability in venture funds depends on balancing of governance and liquidity concerns and specifies plausible factors that are testable using my dataset. It also discusses alternative testable hypotheses. Part V describes the data and variables. Part VI contains regressions and explains which hypotheses receive support in the data. The conclusion summarizes the findings.[4]

4. This Article is a part of a series of empirical studies of various aspects of VC limited partnership agreements. In other work, I study the terms of VC compensation. *See, e.g.*, Kate Litvak, *Venture Capital Partnership Agreements: Understanding Compensation Arrangements, at* http://www.SSRN.com (2004).