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State Legislative Efforts to Improve Access to Venture Capital

Brian K. Krumm

2. State legislative efforts to improve access to venture capital

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The 1983 cover article in *TIME* magazine entitled "The New Economy" was one of the first to discuss the transition from heavy industry to a new, technology-based economy in the United States. That article described a massive complex of aged, red-brick buildings, the former home of a wool mill which was reborn as the new corporate headquarters of Digital Equipment Corporation, the second largest computer manufacturer in the world at the time. The development and growth of Digital Equipment was made possible through financing obtained through venture capital. Venture capital has played an integral part in the evolution from the old to the new economy, yet not all areas of the country have fully participated in this renaissance. This chapter will discuss the role that law, in the form of legislation that creates state-sponsored venture capital programs, can play in providing the capital necessary for states to create an environment that supports entrepreneurs in commercializing their intellectual property.

Access to capital is critical for business startups and expansions and, more importantly, to the health of state and local economies. Despite the need for startup capital, many small businesses find that obtaining such funding is a difficult, or sometimes an even impossible, challenge. The difficulty of small businesses to raise capital is primarily because banks are reluctant to provide conventional debt financing to companies with little to no track record. In the recent economic downturn, this practice has only intensified, with reports suggesting that small business lending has declined as much as 57% in some sectors.[2] Accordingly, traditional debt financing is not an option for many small and emerging businesses.

[1] This chapter is based on research conducted for *Understanding the New Tennessee Small Business Investment Company Credit Act: Stimulating Economic Growth at the Intersection of Free Market Capitalism and Government Intervention,* Transactions: the Tennessee Journal of Business Law, 11 TRANSACTIONS: TENN. J. BUS. 93 (2009).

[2] Emily Maltby, *Small business lending drops 57%*, CNNMONEY.COM, Apr. 3,

As an alternative to conventional financing, venture capital is another resource small businesses turn to when seeking to raise funds. However, like traditional bank financing, access to venture capital by small businesses is also limited. In addition, the supply of venture capital has been traditionally concentrated geographically, focused in a relatively small number of regions and industries. Due to the same risks that prevent banks from lending to startup and emerging businesses, venture capital firms also have an incentive to refrain from investing in companies without a track record of success. In the absence of venture capital funds or traditional bank lending, many small businesses are left with few resources from which they can effectively grow their businesses while maintaining a sufficient cash flow to stay solvent.

THE VENTURE CAPITAL LANDSCAPE

Traditional venture capital financing, in its most basic form, involves three parties: an investor, a venture capitalist, and a target company. Generally, venture capitalists can be viewed as financial intermediaries, meaning they first must convince wealthy individuals, pension funds, corporations, and foundations to trust the venture capitalists with their money, which the venture capitalists will use to make equity investments in privately held companies. Obtaining investments is a difficult task, requiring venture capitalists to prove that they have the experience and track record of making equity investments in companies, monitoring and assisting in their growth, and exiting those investments in such a way as to make substantial profits for themselves and the investors.

Venture capital investment also creates a unique investment dynamic; it typically involves an investment in a company whose stock is essentially illiquid and worthless. Venture capitalists, like many equity investors, bet on the future success of the target company. This success will, in turn, benefit the entrepreneur due to the increased price of their stock and stock options. Typically, even the rank-and-file employees benefit from the stock and option appreciation. Increases in stock prices, however, does not mean much until the asset is sold and the increase in value is realized. Unless the target company is later acquired or goes public after its stock value has appreciated, there is little actual value in the venture capital firm's initial investment. Venture capitalists understand this dynamic and

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2009, http://money.cnn.com/2009/04/02/smallbusiness/smallbiz_loans_drop.smb/index.htm.

invest in companies based on the hope that success will materialize and the venture capitalist and its investors split the profits from the future sale of the company based upon a predetermined formula.[3]

The benefits of venture capital investment in small businesses go far beyond those realized by the direct participants and investors, and are also felt by the overall economy as well. Those companies financed by venture capital investments have historically created jobs at a faster pace than their non-ventured counterparts.[4] Venture-capital-backed companies also demonstrate greater sales growth and comprised 16.6% of the nation's gross domestic product in 2005.[5] All together, the nation's venture-capital-backed companies were directly responsible for 10 million jobs and $2.1 trillion in sales during this same time period.[6] The jobs and revenue generated are largely in innovative, cutting-edge technology and products. Such industries typically benefit the entire economy because they create jobs in high-wage occupations and benefit governmental bodies through their ability to tax such growth.

While investments in risky new ventures are as old as commerce itself, the current venture capital landscape only dates back to 1946 with the

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[3] Venture capitalists are compensated through a combination of management fees and carried interest (often referred to as a "two and 20" arrangement). Management fees are annual payments made by the investors in the fund to the fund's manager to pay for the private equity firm's investment operations. The typical venture capital fund is created as a limited partnership. The general partners receive an annual management fee equal to up to 2% of the committed capital. Carried interest is a share of the profits of the fund (typically 20%), paid to the private equity fund's management company as a performance incentive. The remaining 80% of the profits are paid to the fund's investors. Strong limited partner interest in top-tier venture firms has led to a general trend toward terms more favorable to the venture partnership, and certain groups are able to command carried interest of 25–30% on their funds. Metrick, *infra* note 7, at 11.

[4] Stephane Dupont, *Venture Impact The Economic Importance of Venture Capital Backed Companies To The U.S. Economy*, in ADVANCED VENTURE CAPITAL 2007, 68, 74 (2007). Statistics show that venture capital-backed companies generated an annual jobs growth rate of 4.1% compared to a 1.3% total annual private sector growth rate between 2003 and 2005. *Id.*

[5] Dupont, *supra note* 4 at 65. Venture capital-backed businesses demonstrated an 11.3% annual growth rate in total sales compared to an overall, annual private-sector sales growth rate of 8.5%. Venture capital investments totaled $23 million in 2005, which represented just 0.02% of gross domestic product. The corresponding revenue generated was $2.1 trillion.

[6] *Id.* Venture capital-financed companies are not limited to one segment of the economy. Computers and peripherals, media/entertainment/retail, industrial and energy, software, and telecommunications were the five leading industries by revenue. *Id.* at 77.

formation of the American Research and Development Corporation as the first true venture capital firm.[7] However, this innovation did not significantly change the supply of equity for small and startup businesses. Recognizing this fact, coupled with the desire to take advantage of the benefits conferred on the government by venture capital investment, the federal government sought to encourage venture capital investment as part of the Small Business Investment Act of 1958. This legislation created the Small Business Administration, which led to the creation of Small Business Investment Companies (SBICs). While this legislation did little to immediately increase the available venture capital funding, the SBIC program proved to be an effective vehicle for training future professional venture capitalists. SBICs still exist today and share many of the same characteristics of private venture capital firms; however, they have been prevented from becoming a dominant institutional form because of regulatory restrictions.

One of the most significant changes in venture capital investment occurred in 1979, when U.S. pension fund rules were relaxed to allow pension funds to invest in this asset class. With vast amounts of money to invest compared to the individual investor, pension funds soon began to dominate the venture capital market. In fact, pension funds presently supply nearly half of the money for all venture capital in the United States.[8] Following a surge in venture capital investment after the relaxation of

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[7] ANDREW METRICK, VENTURE CAPITAL AND THE FINANCE OF INNOVATION 3, 10 (Hoboken, NJ: John Wiley & Sons Inc.,2007), *available at* http://ssrn.com/abstract=929145. American Research and Development Corporation was established in 1946 as the first institutional private equity firm. It was a publicly traded corporation and during its 25-year existence it earned an annualized return on its investment of 15.8%. The company is also credited with the first venture capital success story when in 1957 it invested $70,000 in Digital Equipment Corporation, an investment that would be valued at $355 million after the company's initial public offering in 1968. Without this investment, 25-year annualized investment drops to 7.4%. *Id.*

[8] METRICK, *supra* note 7 at 11. The U.S. Labor Department relaxed certain of the Employee Retirement and Security Act (ERISA) restrictions, under the "prudent man rule," thus allowing corporate pension funds to invest in more risky investments and providing a major source of capital available to venture capitalists. The "prudent man rule" is a fiduciary responsibility of investment managers under ERISA. Under the original application, each investment was expected to adhere to risk standards on its own merits, limiting the ability of investment managers to make any investments deemed potentially risky. Under the revised 1978 interpretation, the concept of portfolio diversification of risk, measuring risk at the aggregate portfolio level rather than the investment level to satisfy fiduciary standards, would also be accepted.

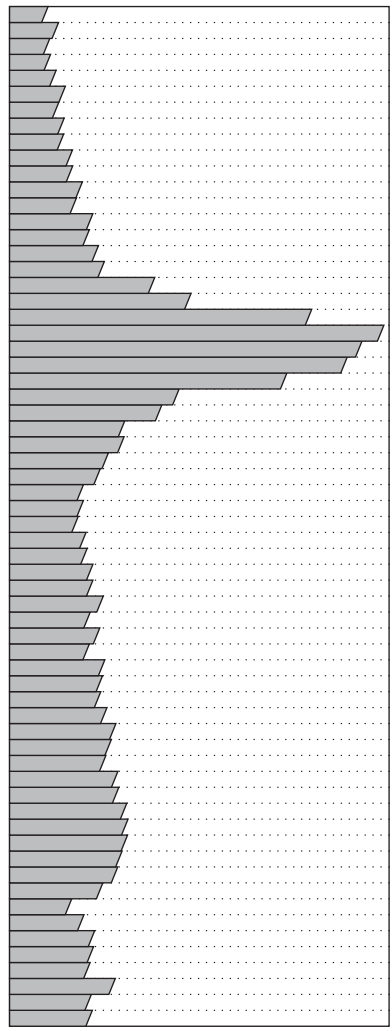
ERISA laws, growth in the venture capital industry remained relatively stable throughout the 1980s. This growth continued throughout the first half of the 1990s, increasing from $3 billion in 1983 to just over $4 billion in 1994.

Then, in the late 1990s, the United States market experienced extraordinary growth in internet and computer technology investments, and venture capitalists were there to share in the profit. Venture capital investments in such companies were yielding spectacular returns, and institutional investors rushed in to participate. Venture capital investments grew from a previous high of around $4 billion in the early 1990s, to an unprecedented level of $105.9 billion in 2000. (See Figure 2.1.) This boom in venture capital investments, however, was short lived. The stock market crash and technology slump that started in March of 2001 shook the entire venture capital market as valuations for technology companies collapsed. Venture capital investments fell by nearly half from the fourth quarter of 2000 to the first quarter of 2001. Nevertheless, current venture capital levels have settled at a considerable increase over those that existed prior to 1995.

Despite the increased prevalence of venture capital funding in the 1980s and 1990s, its availability is isolated in a select few regions of the United States. (See Figure 2.2.) Economic research suggests that there are a number of variables that influence the regional allocation of venture capital. Factors that affect when and where venture capital investments are made include macroeconomic conditions, supply and demand conditions concerning markets for innovations and technological opportunities, and willingness to take risks. Since the regions are not homogeneous with regard to technological areas of expertise, some regions also have a comparative advantage over others as it pertains to regional allocation of venture capital investments.

Currently, the Silicon Valley and New England regions attract the greatest proportions of venture capital, mainly due to the fact that they were centers for information technology innovation during the late 1990s. While Silicon Valley has consistently led the regional allocation of venture capital, the New England region's success is relatively new, as it recently moved to second place among American venture capital hubs, up from fourth out of eighteen regions analyzed in 1995. In 2008, these two regions attracted more than 50% of the total venture capital financing, with the top seven regions attracting 78%.[9] The importance of such agglomeration cannot

[9] George Erber, *Regional Patterns of Venture Capital Financing in the US* 10-11 (DIW Berlin, Working Paper No. 2008/WP03-04, Nov. 2008), 12, 14 *avail-*



Year-Qtr	Amount	% of Total	Deals
Q1 1995	$1581M	0.35%	503
Q2 1995	$2422M	0.34%	455
Q3 1995	$1541M	0.35%	430
Q4 1995	$1489M	0.38%	476
Q1 1996	$2181M	0.49%	581
Q2 1996	$2967M	0.67%	664
Q3 1996	$2346M	0.53%	593
Q4 1996	$2962M	0.66%	763
Q1 1997	$2832M	0.63%	765
Q2 1997	$3501M	0.78%	772
Q3 1997	$3535M	0.79%	754
Q4 1997	$4127M	0.93%	910
Q1 1998	$3791M	0.85%	861
Q2 1998	$5168M	1.16%	909
Q3 1998	$4824M	1.08%	920
Q4 1998	$5584M	1.25%	1004
Q1 1999	$5861M	1.31%	928
Q2 1999	$9997M	2.24%	1319
Q3 1999	$12749M	2.86%	1434
Q4 1999	$22279M	4.99%	1875
Q1 2000	$27091M	6.07%	2154
Q2 2000	$26176M	5.87%	2121
Q3 2000	$24931M	5.59%	1938
Q4 2000	$20404M	4.57%	1760
Q1 2001	$12019M	2.69%	1297
Q2 2001	$10489M	2.35%	1231
Q3 2001	$7585M	1.70%	1017
Q4 2001	$7532M	1.69%	998
Q1 2002	$6442M	1.44%	853
Q2 2002	$5795M	1.30%	868
Q3 2002	$4276M	0.96%	701
Q4 2002	$4225M	0.95%	735
Q1 2003	$4056M	0.91%	716
Q2 2003	$4733M	1.04%	745
Q3 2003	$4624M	1.04%	731
Q4 2003	$5377M	1.21%	798
Q1 2004	$5154M	1.16%	724
Q2 2004	$6019M	1.35%	866
Q3 2004	$4758M	1.07%	701
Q4 2004	$5768M	1.29%	854
Q1 2005	$5008M	1.12%	739
Q2 2005	$6094M	1.37%	837
Q3 2005	$5739M	1.29%	794
Q4 2005	$5694M	1.28%	831
Q1 2006	$6284M	1.41%	883
Q2 2006	$6941M	1.56%	978
Q3 2006	$6644M	1.49%	924
Q4 2006	$6142M	1.38%	969
Q1 2007	$7142M	1.60%	875
Q2 2007	$7207M	1.62%	1067
Q3 2007	$7761M	1.74%	1017
Q4 2007	$7791M	1.75%	1076
Q1 2008	$7807M	1.75%	1027
Q2 2008	$7355M	1.63%	1072
Q3 2008	$7089M	1.59%	1005
Q4 2008	$8034M	1.31%	921
Q1 2009	$3390M	1.76%	637
Q2 2009	$4290M	0.96%	710
Q3 2009	$5212M	1.17%	716
Q4 2009	$5384M	1.21%	864
Q1 2010	$4961M	1.11%	763
Q2 2010	$6900M	1.55%	960
Q3 2010	$4945M	1.11%	789
Q4 2010	$5017M	1.12%	765

Source: PricewaterhouseCoopers/National Venture Capital Association Money Tree Report, based on data from Thomson Reuters.

Figure 2.1 Venture capital investments by year

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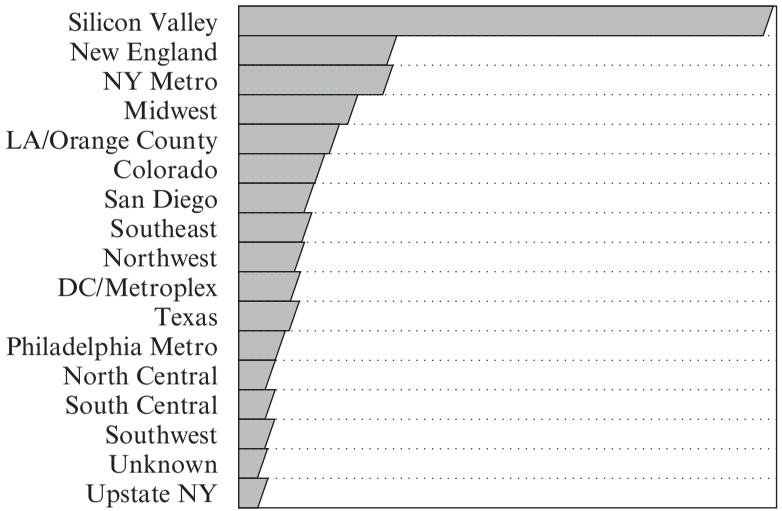
able at http://ssrn.com/abstract=1338633. The top 7 regions in 2008 were: Silicon Valley 39.3%; New England 11.1%; LA/Orange County 7.5%; NY Metro 6.8%; Northwest 4.6%; Midwest 4.4%; and San Diego 4.4%. *Id.* at 25.

Investments by Region/Q4 2010

Regions Defined	Total $ Invested	Average $ Per Deal	Deals
All	$5,017,002,700	$6,558,173	765



	Amount	% of Total	Deals
Silicon Valley	$2001M	39.88%	231
New England	$536M	10.68%	88
NY Metro	$513M	10.22%	83
Midwest	$378M	7.54%	62
LA/Orange County	$305M	6.07%	48
Colorado	$254M	5.06%	24
San Diego	$193M	3.85%	26
Southeast	$191M	3.81%	33
Northwest	$160M	3.20%	33
DC/Metroplex	$143M	2.84%	23
Texas	$138M	2.74%	34
Philadelphia Metro	$85M	1.69%	30
North Central	$46M	0.92%	14
South Central	$34M	0.69%	18
Southwest	$31M	0.61%	8
Unknown	$8M	0.16%	6
Upstate NY	$2M	0.04%	4

Source: PricewaterhouseCoopers/National Venture Capital Association Money Tree Report, based on data from Thomson Reuters.

Figure 2.2 Venture capital investments by region

be overstated, as innovators and startup entrepreneurs all over the world relocate their activities to regional centers in order to have better access to venture capital markets than they have in their own counties and states.

States seeking to take advantage of the benefits of venture capital funding must recognize the driving forces behind the geographic isolation of venture capitalists. Specifically, if states wish to increase their ability to attract an increased share of venture capital, states need to establish a threshold level of venture capital investors. In addition, it is critical that states facilitate a concentration of technological innovation expertise, which promises to contribute to the development of products and services that are in demand in the marketplace.

STATE-SPONSORED VENTURE CAPITAL PROGRAMS

In the late 1970s, a number of states began establishing state-sponsored venture capital programs in order to overcome the market constraints associated with regional concentration of venture capital investment. Several states recognized that they were underserved by the private venture capital market and established state-sponsored venture capital programs attempting to emulate the success of their private sector counterparts. These programs can be categorized in three primary types of venture capital funding: (1) publicly funded and publicly managed funds; (2) public funding provided for privately managed funds; and (3) tax credits or incentives for businesses and individuals making venture capital investments. In addition, some states have undertaken a purely facilitative role by supporting networks of individual investors and venture capital fairs. Under this scheme, the state avoids the obligation of managing the investments of the fund, leaving these responsibilities up to experienced fund managers. In that respect, the state is able to limit both its financial liability and risk.

From a political standpoint, venture capital investments are extremely risky and the total returns on these investments, with a few exceptions, are not as high as popularly believed, given the amount of risk involved.[10]

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[10] *See generally*, YOCHANAN SHACHMUROVE, ECONOMIC GEOGRAPHY, VENTURE CAPITAL AND FOCAL POINTS OF ENTREPRENEURIAL ACTIVITY (PIER Working Paper 09-032, 2009), *available at* http://ssrn.com/abstract=1460823 (This study utilizes thirty years of data concerning companies that initially were backed by venture capital. These firms are located in Entrepreneurial Focal Points in the United States, namely California, Massachusetts, New York, Pennsylvania, and Texas. The study evaluates the returns of both successful and unsuccessful venture capital

State government officials who seek reelection are not typically willing to take on the political risk from lackluster returns or losses, nor are they willing to provide the necessary leadership to make such programs successful. There is a marked difference between an individual making a personal decision to invest their risk capital in a venture capital fund and an elected politician making a decision to invest the public's funds in a risk-laden venture. Thus, the organizational structure of the state-assisted venture capital program selected may be evaluated on a risk/reward continuum.

At one extreme, publicly funded and managed programs allow for greater governmental control by the targeting of investment decisions, allowing the state to focus their investments on specific economic development objectives. These state-sponsored venture capital programs have been met with mixed results. The programs are most often managed by employees of state agencies or quasi-public organizations. The individuals responsible for making investment decisions and providing oversight are typically appointed by the governor. These funds are most often capitalized by public funds generated from state appropriations or bond sales. Because of the substantial reliance on state funding, such funds typically come with restrictions that all or part of the investments must be made within the state and that the investments comply with the state's economic development agenda.

The primary advantage of publicly funded, publicly managed funds is their ability to direct funding toward particular policy objectives or industries. This allows for economic and social impacts to be considered during the investment decision-making process. However, these funds can also face substantial political pressure to make investments in specific areas of the state or in specific businesses that otherwise might not be considered good investments. In addition, publicly managed firms may not be able to attract the most qualified or competent fund managers. States are often at a disadvantage when they seek to take on the management of venture capital investments because their compensation restrictions typically prevent state-managed venture capital programs from attracting top talent from better compensated private firms. Moreover, under this management structure the state also assumes greater direct responsibility for funding the program and for all financial gains and losses that might occur. Such programs have also been criticized for inadequate financing for capitalization and management, government regulations that impeded fund operations, and poor financial returns on fund investments.

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investments. The results show that despite popular beliefs, returns on investment are only adequate given their substantial risk.).

Furthermore, private venture capital firms may not be willing to co-invest with the state-managed funds because of the perception that such funds are overly susceptible to political influence and less responsive to private sector investors. This may limit the fund's ability to invest in a broader range of opportunities and leverage private-sector venture capital.

The Iowa Product Development Corporation (IPDC) was formed in 1983 in response to the downturn in the state's farm economy. The IPDC was housed in the Department of Economic Development, designed to promote economic development by providing seed capital to small businesses with innovative products, services, or ideas. While initially state appropriations and staffing was limited, starting in 1987 annual appropriations increased to approximately $1.5 million a year through the dedication of state lottery receipts for economic development programs. However, state payroll guidelines precluded the hiring of an experienced professional venture capitalist and there was political pressure to make investments outside its investment criteria.

In 1994, the IPDC was restructured as a private, non-profit corporation in response to the State Auditor's questions that IPDC's equity investments were in violation of the Iowa Constitution. Although the financial performance of the fund improved under this new management structure and investment decisions were more insulated from political influence, the fund still suffered from an inability to attract and retain qualified staff due to state pay restrictions. In addition, the program lost its supporters in the state legislative and executive branches due to retirements and election turnover, and the annual appropriations ended in the fiscal year 1997. The fund was forced to operate out of its limited reserves and investment returns and as a result, the fund was terminated in 1998.

While other publicly funded, publicly managed programs such as the Minnesota Technology Corporation Investment Fund created in 1991 and the Small Enterprise Growth Fund created by Maine in 1997 are still in existence in some form today, they have evolved refining their focus from that of their original strategy and objectives, in response to some of the program limitations described above.

Like publicly funded, publicly managed funds, publicly funded but *privately* managed funds generally receive the bulk of their capitalization from public sources. However, unlike their publicly managed counterparts, privately managed funds are organized with a somewhat different purpose. The purpose of these funds is typically to increase the supply of professionally managed venture capital in a region, or to enhance the infrastructure and management capacity of venture capital already existing in the region. These funds tend to focus more on maximizing profits and less on social or economic development objectives. Although the state

sacrifices direct management control over investment management decisions, it gains more limited financial risk and may receive better economic returns.

The structure of capitalization of this type of fund has varied among state programs. Some have obtained state funding with a requirement for a private match or provided additional inducements to encourage private investment. For instance, some funds guarantee a minimum return on investment before the state receives its return; other states forgo a return in order to provide private investors with a premium on their investments. Although publicly funded, privately managed funds have many advantages over their publicly managed counterparts but they are not without disadvantages. These funds are less subject to political pressure, are better positioned to attract experienced managers, and have greater leverage to obtain private capital investments. However, the state's economic development objectives may be overlooked because management's primary focus is on maximizing returns.

The state of Oklahoma has developed perhaps one of the most promising publicly funded, privately managed programs for enhancing and targeting venture capital investments. The state obtains capital for venture investments by borrowing it from institutional lenders and investors. Principal and interest are guaranteed by $50 million in tax credits that are only used if necessary, through prearranged contracts currently with a consortium of public utility companies that have contractually agreed to purchase tax credits through 2015. The Oklahoma Capital Investment Board (OCIB), whose five trustees are appointed by the governor, choose venture capital firms based upon the fund's track record, industry emphasis, interest in the state, and plans for generating deal flow and conducting business in the state. The OCIB seeks to invest $1–5 million in a venture fund as a limited partner representing 10–20% share of the fund with the understanding that the fund will actively seek Oklahoma deals, and that the other private-sector, limited-partner investors and the general partners will conduct the appropriate due diligence on the fund investments and insure that politicians do not influence the fund's investment decisions. If the limited partnerships are successful, the state will realize economic benefits at no cost, and can potentially become self-financing through income from prior investments. Finally, the selection of the portfolio companies for investments is made by professional venture capitalists whose compensation is tied to the success of those investments.

The state of Mississippi, which passed the Venture Capital Act of 1994, provides a classic example of the problems that publicly sponsored venture capital programs can have if appropriate government oversight is not exercised and where the incentive systems do not reward making sound

investment decisions. During the fund's two-and-one-half year history, the $18 million fund incurred expenses of over $4.5 million while approving only one venture capital investment of $650,000. Management misappropriation caused the fund's private investor to withdraw most of its contribution, and the program was placed under the protection of Chapter 11 reorganization.

Regardless of whether publicly funded venture capital funds are privately or publicly managed, there are several public-funding issues that policy makers and venture capitalists trying to create new funds should consider. Public funding should be provided in one lump sum rather than as an annual appropriation over a period of time in order to ensure effective program buy-in and continuity. While it may be more difficult to convince state legislators to make large, lump-sum investments, the uncertainties of the economy and the political process make program dependency on annual appropriations unappealing to private-sector venture capital funds. In addition, funds receiving annual appropriations may be prone to make suboptimal investment decisions because of pressure to use the appropriation before year end for fear that additional appropriations will not be authorized. Furthermore, capital venture investments may experience failures before successes occur. Such failures can have a cooling effect on the legislative support for future appropriations, jeopardizing both current and future investment decisions.

A third type of state-sponsored venture capital program provides incentives, often in the form of tax credits, to encourage private venture capital investments. In this form of venture capital legislation, the state's control is limited to the restrictions outlined in the enabling legislation and the state does not always share in the direct financial gains that these investments may achieve. These programs have been referred to as Certified Capital Corporation programs (CAPCOs). The first CAPCO legislation was passed in Louisiana in 1983. Since this time a number of other states have adopted similar legislation.[11] Under the typical CAPCO-enabling legislation, the state offers tax credits to insurance companies in return for "certified investments" in CAPCOs.[12] The tax credits are available to

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[11] Other states that have adopted the CAPCO model are Missouri, New York, Wisconsin, Florida, Kansas, Texas, Vermont, Colorado, Alabama, and the District of Columbia.

[12] David L. Barkley et al., *Certified Capital Companies (CAPCOs): Strengths and Shortcomings of the Latest Wave in State-Assisted Venture Capital Programs*, 15 ECON. DEV. Q. 290, 352 (2001), *available at* http://edq.sagepub.com/cgi/content/ abstract/15/4/350. For various legal and practical reasons, the benefits of investing in CAPCO programs have generally been restricted to

offset future tax obligations that insurance companies pay on premiums collected in the state.[13] Thus they are basically investing in a guaranteed security rather than a risky investment. In addition, these tax credits are usually salable or transferable by the insurance companies.

In order to build upon and enhance the existing venture capital infrastructure in the state, CAPCOs are generally selected from well-established, private-sector venture capital funds that become certified with the state. Certification requirements established by the state include, among other things, minimum capitalization requirements, investment experience requirements, and the establishment of an in-state office. Once the funds are selected and certified as CAPCOs, they must meet certain

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insurance companies. Insurance companies are a significant source of investment funds and, in every state, are subject to a premium tax (a levy imposed on the premiums insurers receive). Because the insurance companies typically pay premium taxes in lieu of income taxes, they generally do not benefit from income tax credits. Thus, to encourage insurance companies to invest their considerable cash reserves in state-restricted venture capital funds, states include the premium tax credits as a key component of their CAPCO programs. Velislava Groudkova et.al., *CAPCO Programs Offer Tax Credits to Attract Venture Capital for Small Businesses*, THE JOURNAL FOR MULTISTATE TAXATION AND INCENTIVES, June 2002 *available at* http://capcoprogram.com/2009/09/capco-programs-offer-tax-credits-to-attract-venture-capital-for-small-business.

[13] Insurance company regulations prohibit insurance companies from investing in venture capital funds as a limited partner, as is typically the case with traditional venture capital funds. The CAPCO model is a mechanism that is approved by the National Association of Insurance Commissioners, which provides a relatively secure rate of return on the insurance company's investment. A premium tax credit is unique because of the consistent nature of premium taxes, which are less prone to year-to-year fluctuation than income tax credits. While predicting taxable income in future years can be difficult, insurance companies may easily estimate the future receipts on which their premium tax will be based. As a result, states can predict with increased accuracy the fiscal impact of a credit against premium tax. Because of the greater certainty of the premium tax credit, an insurance company is more likely to factor the value of the credit into its investment calculations. Because insurance companies generally are sophisticated, long-term investors in fixed-income instruments, the premium tax credit enhances the expected return and encourages participation in the CAPCO program. For these reasons, states may derive more predictable economic development benefits from a premium tax credit for investments in CAPCOs than from a credit claimed against income taxes. The premium tax credit for CAPCO investments attracts funding that otherwise would not have been invested in the newly formed venture funds. Velislava Groudkova et.al., *CAPCO Programs Offer Tax Credits to Attract Venture Capital for Small Businesses*, THE JOURNAL FOR MULTISTATE TAXATION AND INCENTIVES, (June 2002), *available at* http://capcoprogram.com/2009/09/capco-programs-offer-tax-credits-to-attract-venture-capital-for-small-business.

established investment criteria, and invest 100% of the certified capital, before any of the investment gains can be distributed to the partners. Traditionally, CAPCO fund managers have been allowed to receive an annual management fee, usually no more than 2.5% of capital available for investment for expenses necessary to operate the fund.

The state-enabling legislation also commonly creates a means for CAPCOs to become decertified, either voluntarily or as a result of non-compliance with the rules established for their operation. Generally, involuntary decertification occurs when it fails to meet the requirements for raising certified capital, or when it has not met the investment requirement under the legislation. Voluntary decertification typically occurs when the CAPCO has met its investment objectives, and the small business is ready to go public, be acquired, or otherwise repay the investment. The CAPCO may then choose to decertify, and consequently make distributions of its profits.

CAPCOs must make investments in "qualified businesses" as defined in the enabling legislation. In defining "qualified businesses," the state is essentially targeting the types of businesses it wants to support in order to meet its economic development objectives. Generally, qualified businesses must be small, located and operated within the state, with most of the employees residing in the state.[14] Once again, depending on the state's particular economic development objectives, certain sectors of the economy are specifically excluded from participating as qualified businesses. CAPCO investments must be made in qualified businesses in order to ensure the availability of tax credits for insurance company investors.

In return for the sacrificed tax revenues from the insurance companies that receive the tax credits, the state anticipates receiving sufficient new tax revenues from the businesses that start, expand, and remain within the state as a result of the CAPCO investments. There are also ancillary tax revenues in the form of increased sales tax and income tax from the employees who work in these businesses, not to mention indirect and induced benefits from the increased economic activity.[15] Some states have

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[14] The Small Business Administration definition of a small business varies by major industry group but generally includes businesses of fewer than 500 employees for manufacturing and less than $5 million in annual sales for retail trade and services.

[15] Tucker Adams, GROWTH CAPITAL ALLIANCE, THE COLORADO CAPCO PROGRAM: AN ANALYSIS 22 (2003), *available at* http://www.coloradoeconomy.com/downloads/CAPCOstudy.pdf. Indirect benefits are "generated by the purchase of goods and services by the businesses that are the original recipients of CAPCO dollars. For example, the purchase of computers, office supplies and cleaning services by" the

also incorporated provisions in their legislation that would allow them to participate directly in the investment returns of the CAPCO investments, in addition to the anticipated increase in future tax revenues.

State governments provide oversight of CAPCOs by requiring that they report on an annual basis to designated regulatory authorities. Typically, CAPCOs are required to report the identity of each investor, the amount of each investment, and the amount of the investment tax credit allocated on the basis of such investment. Information is also collected on the identity, type, size, location, and the amount invested in each of the target companies invested in by the fund manager. Some states require the CAPCO to also report the number of jobs created by the investment in the qualified business, along with their audited financial statements.

As mentioned above, state-managed venture capital programs are heavily criticized for inadequate financing for capitalization and management, lack of expertise in fund management, perception of political influence in investment decisions, government regulations that impeded fund operations, and poor financial returns on fund investments. CAPCO programs, however, are not nearly as susceptible to such criticisms. First, because CAPCOs are capitalized through the use of tax credits, they do not require current state budget expenditures or bond sales.[16] The actual cost of the tax credits to the state is reduced by the allocation of tax credits over time. Funding CAPCOs with tax credits and spreading tax credits over ten years make CAPCOs an attractive alternative when compared to programs that require current expenditures of debt. Furthermore, CAPCOs have another advantage over other publicly funded venture capital programs in that they can usually raise significant funding from insurance companies in a relatively short period of time.

Second, traditional publicly funded and managed venture capital programs are also commonly constrained by state pay regulations and are

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companies being funded by the venture capital. *Id.* Induced benefits are those that are generated by the economic activity produced from "the purchase of goods and services by the individuals whose incomes are derived directly or indirectly from [the venture capital-funded] companies. The purchase of groceries, a car, or a home is an example of induced economic activity." *Id.*

[16] CAPCOs do not require current expenditure of funds or bond sales as do publicly funded and publicly managed and publicly funded and privately managed venture capital funds. The cost to the state for CAPCOs is the present value of future tax revenues lost due to tax credits over a ten-year period. For public investments in public or private venture capital funds, the cost to the state is typically the current lump-sum value of state funds invested. If returns from program investments were poor, the state treasury would lose less with a program financed with ten years of tax credits than with a program funded with one lump-sum payment.

limited to how much they can compensate public fund managers. This creates problems because experienced venture capital fund managers are highly compensated and, thus, not attracted to manage public funds due to relatively low compensation structures. CAPCOs, on the other hand, are more able to attract experienced fund managers because of higher salary, profit sharing allowances, and other benefits.

Third, with respect to publicly managed venture capital funds, there is a perception of, if not the potential for, political interference with investment decisions. Similarly, with publicly funded and privately managed funds, there is the potential for political interference in the selection of the private firms. The CAPCO management structure, which limits the state's role to certifying the capital companies, reduces the political pressure to place state monies with specific private venture firms. The participating insurance companies select the certified CAPCOs in which to place their funds, which diminishes any political pressure to make an investment in a specific business. Because the CAPCO is insulated from political influence, private venture funds are more inclined to co-invest with the privately managed CAPCO, thus increasing the fund's ability to participate in syndicated deals and leverage their certified capital.

While the CAPCO model appears to offer advantages over other types of state-sponsored venture capital programs, policy makers who are considering implementing a venture capital program need to evaluate the CAPCO model in conjunction with an understanding of their state economy, the availability of venture capital resources, and the political environment, in order to develop a model which is appropriate for their state.

ECONOMIC AND PROGRAM EVALUATION

It has been over twenty-five years since the first CAPCO legislation was passed. During this time similar legislation has been implemented in nine additional states and the District of Columbia. As is the case with many government programs, disparities often exist between the vision and intent of legislation and the reality of its programmatic implementation. Only after the passage of time can one evaluate whether a program is meeting its intended objectives and whether it is being managed in an efficient and cost-effective manner. Once an evaluation is conducted, policy makers can then determine whether the legislation should be repealed, amended, or improved upon through the implementation of additional management and oversight controls.

Evaluations of CAPCO programs conducted to date tend to emphasize the economic development benefits of growing high-wage professional,

scientific, and technical service industries within the state as opposed to focusing primarily on the recruitment of large-scale manufacturing projects. The highly competitive bidding process that takes place between states for high-profile manufacturing projects, where each state attempts to out bid the other using subsidies and tax abatements, is an expensive zero-sum game. It is important to remember that the overriding objective of CAPCO programs is economic development. By instituting a CAPCO program, states seek benefits much broader than direct venture capital profit. As those who are familiar with economic development know, these broader benefits are more meaningful for the state's long-term economic well being, but extremely difficult to quantify or attribute to one specific program. The very nature of venture capital for seed or early-stage financing does not immediately translate into quantitative measures such as "number of jobs created" or "average salary of jobs created" that are standard measures when measuring the impact of economic development programs. While the effects of venture capital investment in terms of these quantitative measures are often not immediately realized, each state can point to success stories where the outcomes far exceed the investment. However, despite the promising economic development impact of CAPCO programs, there exist opportunities for improvement in program implementation.

The expansion of CAPCO programs since the late 1990s was due in large part to the lobbying efforts of relatively concentrated CAPCO fund management groups. Four CAPCO fund management groups control the bulk of the industry across the United States.[17] One criticism of CAPCO programs is that they have enriched fund management groups while doing little to support early-stage entrepreneurship within the state. In fact, CAPCO programs have been accused of actually hurting the state venture capital industry. This criticism originates from the fact that CAPCO management groups have existing relationships with insurance companies through CAPCO programs in other states. Accordingly, these management groups have traditionally been able to use these preexisting relationships to quickly obtain insurance company investment commitments, locking up all of the tax credits among themselves and precluding local venture capital funds from participation in the program. Additionally,

[17] *Id.* The four major CAPCO fund management groups are: Advantage Capital, Enhanced Capital, Stonehenge Capital, and Newtek. These four fund-management groups accounted for approximately 80% of the $1.65 billion of the total state tax credits granted between 1986 and 2001 in all CAPCO programs across the United States. *See* Daniel Sandler, *State-Sponsored Venture Capital: Are CAPCOs a Solution or a Problem?,* (2004) *available at* http://prowlingowl.com/Scams/CAPCO/CAPCOsAProblem2.cfm.

because CAPCOs have cost advantages in raising capital, they often offer more favorable investment terms to their portfolio companies. This may result in existing out-of-state, fund-management groups crowding out other in-state venture capital providers and discouraging new venture capital formation in the state.

Evaluations of other CAPCO programs also reveal that they tend to make few seed or startup investments. This is because their primary focus is on maximizing profitability within the parameters outlined in the state-enabling legislation. As such, to the greatest extent possible, they try to make later-stage investments that carry lower risk and present the best potential for a quick return on investment. In addition, in contrast to their private sector counterparts that profit from exiting carefully chosen investments in high-growth companies, CAPCO profits come from decertifying from the CAPCO program once they have invested 100% of their tax credit allocation. Once decertified, the CAPCO is able to retain all of the taxpayer money that is not lost through the investment process. As a result, there is an incentive for the CAPCOs to invest the taxpayers' dollars in a manner that insures the fastest and safest return, and a disincentive to making long-term equity investments in high-growth companies that maximizes economic growth and job creation.

While all state-sponsored venture programs result in new costs as well as potential new revenues, CAPCOs can be a more costly way of increasing equity capital in the state compared to other state venture capital programs. Under the CAPCO model, the net cost to the state depends on the performance of the fund, as represented by the present value of future tax revenues exercised ratably over a ten-year period. In contrast, the cost to the state for alternative investments in private or public venture capital funds is typically the current value of the lump-sum investment. All things being equal, if investment returns are poor or if there is a loss, the state will lose less with a program financed by ten years of tax credits compared to a program that is funded in one lump sum. On the other hand, in situations where CAPCOs and other publicly funded venture capital programs break even or are profitable, CAPCOs will have a higher net cost to the state. Unlike the other forms of publicly funded programs, the proceeds from CAPCO investments are distributed to the insurance companies, other equity investors, and fund managers, and the state does not usually receive a share of the returns from the CAPCO investments to defray program costs.

The state of Tennessee is the most recent state to enact a state-sponsored venture capital program. The Tennessee legislation, while initially promoted by the CAPCO industry, has diverted significantly from the traditional CAPCO model, with an eye toward overcoming many of the CAPCO shortcomings. While the Tennessee Program is designed to vest

fund management in private fund managers, it also has established clear parameters and metrics for the investment of funds that help place greater emphasis on the state's economic development objectives. In addition, it allows for the state to participate as a limited partner in any profits that are generated through the program.

THE TNINVESTCO PROGRAM

The Tennessee Small Business Investment Company Credit Act[18] (the "Act") is similar in many respects to the legislation that created CAPCO programs that have been established in a number of other states. The Act and its 2010 amendment creates ten certified venture capital funds, each referred to as a "TNInvestco,"[19] which have been authorized to receive a total of $200 million in investment tax credits to be offered to insurance companies ("Participating Investors") in exchange for capital commitments in the TNInvestco. These tax credits can be used incrementally, beginning in 2012, by Participating Investors to offset certain tax liabilities imposed by the state on the collection of insurance premiums. While the Act's passage has produced some skeptics, the Tennessee business community has lauded this initiative as a mechanism for the state to diversify its economy into higher wage industries at a time when Tennessee is experiencing declining nominal personal income growth, declining wage growth, and a state revenue shortfall.[20]

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[18] §§ 4-28-101 to 112 (Supp. 2009) (approved by the Tennessee General Assembly as H.B. 2085, 106th Gen. Assy. (Tenn. 2009)). The legislation had a total of 82 formal co-sponsors in the Tennessee House and Senate. Tenn. Gen. Assy., Bill Summary, *available at* http://wapp.capitol.tn.gov/ apps/billinfo/BillSummaryArchive.aspx?BillNumber=HB2085&ga=106. The TNInvestco program passed in the Senate 30-0 and in the House 94-0, with one abstention. Tenn. Gen. Assy., Floor and Committee Votes, *available at* http://wapp.capitol.tn.gov/apps/BillInfo/BillVotesArchive.aspx?chambervoting =s&BillNumber=SB1203&ga=106; Tenn. Gen. Assy., Floor and Committee Votes, *available at* http://wapp.capitol.tn.gov/apps/BillInfo/BillVotesArchive.aspx?chambervoting=H&BillNumber=HB2085&ga=106.

[19] TENN. CODE ANN. §§ 4-28-101 to 112 (Supp. 2009) at § 4-28-102(16). TNInvestco is the name given in Tennessee's legislation to the venture capital firms that are certified by the Tennessee Department of Economic and Community Development to receive an investment tax credit allocation. *Id.* In essence, TNInvestco is merely the term adopted by the state legislature to describe Tennessee's version of a CAPCO.

[20] THE UNIVERSITY OF TENNESSEE CENTER FOR BUSINESS AND ECONOMIC RESEARCH, AN ECONOMIC REPORT TO THE GOVERNOR OF TENNESSEE 22, 24-26 (2009), *available at* http://cber.bus.utk.edu/tefs/erg2009.pdf.

The TNInvestco program was designed to overcome some of the shortcomings of the CAPCO programs. For example, the TNInvestco program has avoided the undue influence of the out-of-state CAPCO management groups by giving a preference to venture capital funds with a well-established history of investing in Tennessee small businesses. Notably, the Act requires that each TNInvestco applicant be based, and have its principal office, in the state of Tennessee for at least five years or, alternatively, have at least five years' experience in investing primarily in Tennessee-domiciled companies. For those applicants that did not meet these criteria, an opportunity was afforded to enter into a joint venture with applicants meeting these standards. This provision is designed to ensure that the state develops and expands its own venture capital base and prevents the preexisting relationships that exist between the insurance industry and CAPCO management groups from limiting the TNInvestco's access to capital from insurance companies.

The Act also incorporates parameters that require all TNInvestco applicants to present a strategy for focusing investment of capital in seed or early-stage companies with high growth potential. In addition, it reinforces this policy through the application of investment performance measures, which places strict requirements on TNInvestcos to provide seed and early-stage financing. Qualified investments that are seed or early-stage investments receive a 300% credit toward the yearly investment performance measurement thresholds that the TNInvestcos have to meet beginning two years after the tax credit allocation. This encourages TNInvestco fund managers to seek out small business investments, especially during the initial few years of the TNIvestco program, in order for them to more easily meet their performance objectives. This also serves to temper the venture fund manager's tendency to make investments in businesses that insure the fastest and safest return, and an incentive to make long-term equity investments in high-growth companies that maximizes economic growth and job creation.

From a fiscal standpoint, perhaps the most significant improvement in the CAPCO model is the requirement that the state receive a portion of any non-qualified distributions made by the TNInvestcos. The Act's imposition of a "Profit Share Percentage," which imposes a fee of 50% of all non-qualified distributions made by the TNInvestco, allows the state to equitably participate in the fund's upside potential. In the event that TNInvestco is profitable, not only can the state enjoy potential future tax revenues, but it will also repay the treasury for the amount of revenue foregone pursuant to the tax credits allocated to the insurance industry. In addition, the Act prevents TNIvestcos from making any investment distributions that include the base investment amount until after the seventh

year of the fund's operation. This provision should help to provide an equitable balance between the TNInvestco's desire to rapidly maximize its return on investment, and the economic development objectives of making longer-term investments in high-growth companies.In sum, the enhancements made to the fundamental CAPCO model through the TNInvestco-enabling legislation certainly have the potential to make the program a more cost-effective mechanism to stimulate small business development in Tennessee. The drafters of the legislation have obviously benefited from the lessons learned in other states that have adopted the CAPCO model.

CONCLUSION

State-sponsored venture capital programs, if established correctly and managed properly, can prove to be an effective economic development tool that enables a state to encourage private sector investment activity in target industries and geographic areas. Those states that have implemented venture capital programs based upon the fundamental CAPCO model have made numerous changes over time. For example, the Louisiana program has subsequently instituted a state profit-sharing component to their program. The state of Florida, in addition to incorporating a profit-sharing provision, has required any business receiving venture funds to keep their headquarters and any manufacturing facilities in the state for ten years. New York's legislation targets investment in early-stage businesses by requiring that at least 50% of the fund be invested in such businesses within four years. These changes to the fundamental CAPCO model have evolved over time, based upon the lessons learned from both internal operations and the sharing of experiences between state programs.

The TNInvestco-enabling legislation incorporates a number of unique improvements that are designed to avoid many of the problems encountered by other state-sponsored venture capital programs. Despite these improvements, one should anticipate new issues arising. On-going program monitoring is essential to address such unanticipated issues and correct them proactively. Those states that anticipate embarking upon a state-sponsored venture capital program should continue to refine and build upon the lessons learned to date.