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UNDERSTANDING THE NEW TENNESSEE SMALL BUSINESS INVESTMENT COMPANY CREDIT ACT: STIMULATING ECONOMIC GROWTH AT THE INTERSECTION OF FREE MARKET CAPITALISM AND GOVERNMENT INTERVENTION

BRIAN KRUMM¹

Access to capital is critical for business startups and expansions and, more importantly, to the health of state and local economies.² Despite the need for startup capital, many small businesses find that obtaining such funding is a difficult, or sometimes even impossible, challenge. Small businesses have difficulty raising capital 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.³ Accordingly, traditional debt financing is not an option for many small and emerging businesses.

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 on a relatively small number of regions and

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² 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, 350 (2001), available at <http://edq.sagepub.com/cgi/content/abstract/15/4/350>.

³ Emily Maltby, *Small Business Lending Drops 57%*, CNNMONEY.COM, Apr. 3, 2009, http://money.cnn.com/2009/04/02/smallbusiness/smallbiz_loans_drop.smb/index.htm.

industries.”⁴ Venture capital firms also have incentive to refrain from investing in companies without a track record of success due to the same risks that prevent banks from lending to startup and emerging businesses.⁵ 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.

In response to these concerns, the Tennessee General Assembly passed the Tennessee Small Business Investment Company Credit Act (the “Act”) on June 18, 2009, a bill that was later signed into law by Governor Phil Bredesen on July 9, 2009.⁶ The Act is designed to fill the gap that exists in equity financing by providing incentives to the private sector to make investments to small and start-up businesses which otherwise would not receive such funding.⁷ Specifically, tax credits are offered to insurance companies in exchange for current investments in qualified Tennessee venture capital funds that, in turn, invest this capital in Tennessee small businesses.⁸ Because the tax credits authorized in the Act are issued and exercisable over time, the state expends no current resources, and future costs of these credits are further

⁴ Barkley, *supra* note 2, at 350.

⁵ Drew Ruble, *Where It's Due: The Tennessee Legislature Does Something Right for the State's Economy*, BUSINESS TN, Sept./Oct. 2009, available at <http://www.businesstn.com/content/2000909/where-its-due>; see also Marjan Petreski, *The Role of Venture Capital in Financing Small Businesses*, J. OF ENTREPRENEURSHIP & FIN. (forthcoming) (manuscript at 3-4), available at <http://ssrn.com/abstract=906876>.

⁶ Tennessee Small Business Investment Company Credit Act, T.C.A. §§ 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, <http://wapp.capitol.tn.gov/apps/billinfo/BillSummaryArchive.aspx?BillNumber=HB2085&ga=106>. Boosted by the Bredesen Administration's support, 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, <http://wapp.capitol.tn.gov/apps/BillInfo/BillVotesArchive.aspx?chambervoting=s&BillNumber=SB1203&ga=106>; Tenn. Gen. Assy., Floor and Committee Votes, <http://wapp.capitol.tn.gov/apps/BillInfo/BillVotesArchive.aspx?chambervoting=H&BillNumber=HB2085&ga=106>.

⁷ See TENN. DEP'T OF REV., TENNESSEE SMALL BUSINESS INVESTMENT COMPANY CREDIT ACT NOTICE # 09-00 (Aug. 2009), http://tennessee.gov/ecd/tinvestco/pdf/TNInvestco%20Act%20notice%20v3_2.pdf.

⁸ See *id.*

reduced by time-value-of-money principles.⁹ In addition to the potential for increased tax revenues generated by the new and growing businesses and their employees, the Act entitles the state to 50% of the distributions made from the venture capital fund to investors, essentially making the state of Tennessee a true partner in the equity investment.¹⁰ Under this framework, the Tennessee legislature hopes to spur the growth of small and emerging business without large initial expenditures or the current issuance of debt.¹¹

While the Act's passage has produced some skeptics, the Tennessee business community has generally 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.¹² This article will discuss the development of venture capital and its importance in promoting entrepreneurial innovation and economic development. It will provide the reader with a background and understanding of the challenges encountered in similar state-sponsored venture capital programs. In addition, it will provide an overview of how the provisions of the Act are designed to enhance Tennessee's venture capital environment. It will conclude by identifying a number of issues that must be overcome in order for the legislation to achieve its intended objectives.

I. 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

⁹ TENN. CODE ANN. § 4-28-103(a) (West 2010).

¹⁰ TENN. CODE ANN. § 4-28-109(a)(1) (West 2010).

¹¹ See generally *Hearing Before the H. Commerce Comm.*, 106th Gen. Assem. (May 15, 2009); available at <http://wapp.capitol.tn.gov/apps/BillInfo/Default.aspx?BillNumber=HB2085> (outlining the Tennessee Small Business Investment Company Credit Act).

¹² See Milt Capps, *Sidebar: Opinions on CAPCO Vary Among VCs*, VENTURE NASHVILLE CONNECTIONS Oct. 23, 2009, <http://www.venturenashville.com/sidebar-opinions-on-capco-vary-among-vcs-cms-271>; Ruble, *supra* note 5; 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 venture capitalists with their money, which the venture capitalists will then use to make equity investments in privately held companies.¹³ 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.¹⁴

Venture capital investment also creates a unique investment dynamic; it typically involves an “investment in a company whose stock is essentially illiquid and worthless.”¹⁵ Venture capitalists, like many equity investors, bet on the future success of the target company.¹⁶ This success will, in turn, benefit the entrepreneur due to the increased price of his or her stock and stock options.¹⁷ Typically, even the “rank and file” employees benefit from the stock and option appreciation.¹⁸ Increases in stock prices, however, are much like increases in the value of a coin collection; it 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.¹⁹ Venture capitalists understand this dynamic and invest in companies based on the hope that success will materialize and the venture capitalist

¹³ ANDREW METRICK, *VENTURE CAPITAL AND THE FINANCE OF INNOVATION 3* (2007), available at <http://ssrn.com/abstract=929145>. Typically a venture capital fund is formed as a limited partnership, with the venture capitalist acting as the general partner and the investors acting as limited partners. *Id.*

¹⁴ *See generally id.* at 1-6. In addition to providing necessary capital, the venture capitalists typically provide a management oversight function, often taking one or more positions on the board of directors that allow them to provide advice and support at the highest levels. Start-up companies often have a difficult time attracting high quality talent; venture capitalists can play an important role in mitigating this problem by drawing upon their industry reputation and contacts, and by recruiting the necessary talent to make the venture successful. *Id.* at 5.

¹⁵ Stephane Dupont, *Venture Impact: The Economic Importance of Venture Capital Backed Companies to the U.S. Economy*, in *ADVANCED VENTURE CAPITAL 68* (2007).

¹⁶ *Id.* at 71. Venture capital investments are long-term investments, typically three to six years. While investors are always optimistic about the potential returns of the company receiving funding, only one in six target companies ever go public, and only one in three target companies ever reach a level of success where the target is acquired by a third party. *Id.* at 70.

¹⁷ *Id.* at 71.

¹⁸ *Id.*

¹⁹ *Id.* at 69.

and its investors split the profits from the future sale of the company based upon a predetermined formula.²⁰

The benefits of venture capital investment in small businesses go far beyond those realized by the direct participants and investors; the benefits are 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.”²¹ Venture-capital-backed companies also demonstrate greater sales growth and comprised 16.6% of the nation’s gross domestic product in 2005.²² 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.²³ The jobs and revenue generated are largely in “innovative and cutting-edge technology and products.”²⁴ 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.

²⁰ *Id.* at 70. Venture capitalists are compensated through a combination of management fees and carried interest. METRICK, *supra* note 13, at 11. 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. *Id.* 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. *Id.* at 11. 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. *Id.* The remaining 80% of the profits are paid to the fund’s investors. *Id.* 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 15-30% on their funds. *Id.* at 11. For a more comprehensive understanding of venture capital compensation arrangements, see Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements* (Univ. of Tex. Law & Econ. Research Paper No. 29; Columbia Law & Econ. Working Paper No. 254, 2004), available at <http://ssrn.com/abstract=555626>.

²¹ Dupont, *supra* note 15, at 74. Statistics show that venture capital backed companies generated an annual job growth rate of 4.1%, compared to a 1.3% total annual private sector growth rate between 2003-05. *Id.*

²² *Id.* 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%. *Id.* Venture capital investments totaled \$23 billion in 2005, which represented just 0.2% of gross domestic product. *Id.* The corresponding revenue generated was \$2.1 trillion. *Id.*

²³ *Id.*

²⁴ *Id.* at 72. 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.

While investments in risky new ventures are as old as commerce itself, the current venture capital landscape only dates back to 1946, with the formation of the American Research and Development Corporation as the first true venture capital firm.²⁵ However, this innovation did not significantly change the supply of equity for small and start-up businesses.²⁶ 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 1958.²⁷ This legislation created the Small Business Administration, which led to the creation of Small Business Investment Companies (“SBICs”).²⁸ 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.²⁹ 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.³⁰

²⁵ METRICK, *supra* note 13, at 10. The American Research and Development Corporation was established in 1946 as the first institutional private equity firm. *Id.* It was a publicly traded corporation, and during its “25-year existence . . . [it] earned annualized returns for its investors of 15.8 percent.” *Id.* The company is also credited with the first venture capital success story in 1957, when 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. *Id.* Without this investment, “American Research and Development Corporation’s 25-year annualized investment drops to 7.4 percent.” *Id.*

²⁶ *Id.* at 11.

²⁷ Small Business Investment Act of 1958, Pub. L. No. 85-699, § 102, 72 Stat. 689 (prior to amendment).

²⁸ Pub. L. No. 85-699 § 301, 72 Stat. 689 (1958) (codified as amended at 15 U.S.C. § 661).

²⁹ METRICK, *supra* note 13, at 11. Total venture capital funding in the United States remained less than \$1 billion a year during the 1970s. *Id.*

³⁰ *Id.* Small Business Investment Companies (“SBICs”) are venture funds and other privately owned investment firms that have received loans from the Small Business Administration (“SBA”) under its SBIC program. BRUCE K. MULOCK, SMALL BUSINESS ADMINISTRATION: OVERVIEW AND ISSUES 5 (2002). SBICs use the loan proceeds received by the SBA to augment their private funds, and to invest in qualifying companies. Lawrence S. Mondschein, *Small Business Investment Companies*, COMMUNITY INVESTMENTS MAG. 16 (March 2002), available at <http://www.frbsf.org/publications/community/investments/cra02-2/sbic.pdf>. Typically, SBICs are eligible to receive up to 300% of private equity raised. 13 C.F.R. § 107.1150(a) (2005).

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.³¹ With vast amounts of money to invest compared to the individual investor, pension funds soon began to dominate the venture capital market.³² In fact, pension funds presently “supply nearly half of the money for all venture capital in the United States.”³³ Following a surge in venture capital investment after the relaxation of ERISA laws, growth in the venture capital industry remained relatively stable throughout the 1980s.³⁴ This growth continued through the first half of the 1990s, increasing from \$3 billion in 1983 to just over \$4 billion in 1994.³⁵

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.³⁶ Venture capital investments in such companies were yielding spectacular returns, and institutional investors rushed in to participate.³⁷ Venture capital investments grew from a previous high of around \$4 billion in the early 90s to an unprecedented level of \$105.9 billion in 2000.³⁸ 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 2001.³⁹

³¹ METRICK, *supra* note 13, at 11.

³² *Id.* at 11-12.

³³ *Id.* at 12.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *See id.*

³⁷ *See id.* Investments rose to \$11.5 billion in 1996, \$14.8 billion in 1997, \$21.2 billion in 1998, and \$54.4 billion in 1999, reaching an all-time high of \$105.9 billion in 2000. *Id.*

³⁸ *Id.*

³⁹ *Id.* Although the post-boom years represent just a small fraction of the peak levels of venture investment reached in 2000, they still represent an increase over the levels of investment from 1980 through 1995. *Id.* at 13. Venture investment was 0.0587% of GDP in 1994, peaked at 1.087% (nearly 19 times the 1994 level) in 2000 and ranged from 0.164% to 0.182% in 2003 and 2004. *Id.* The revival of an Internet-driven environment from 2004 through 2007 helped to revive the venture

Nevertheless, current venture capital levels have settled at a “considerable increase” over those that existed prior to 1995.⁴⁰

Despite the increased prevalence of venture capital funding in the 80s and 90s, its availability has traditionally been isolated to a select few regions of the United States.⁴¹ Economic research suggests that a number of variables influence the regional allocation of venture capital.⁴² Factors that affect when and where venture capital investments are made include “macroeconomic conditions, technological opportunities and willingness to take risks . . . and supply [and demand] conditions concerning markets for innovations”⁴³ 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.⁴⁴

Currently, Silicon Valley and New England regions attract the greatest proportion of venture capital, mainly due to the fact that they were centers for information technology innovation during the late 90s.⁴⁵ 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 18 regions analyzed in 1995.⁴⁶ In 2008, these two regions attracted more than 50% of the total venture capital financing, with the top seven regions attracting 78%.⁴⁷ The importance of such agglomeration

capital environment. *Id.* However, as a percentage of the overall private equity market, venture capital has still not reached its mid-1990s level, let alone its peak in 2000. *Id.*

⁴⁰ *Id.* at 13.

⁴¹ *Id.* at 20.

⁴² George Erber, *Regional Patterns of Venture Capital Financing in the US* 10-11 (DIW Berlin, Working Paper No. 2008/WP03-04, Nov. 2008), available at <http://ssrn.com/abstract=1338633>.

⁴³ *Id.* at 11.

⁴⁴ See METRICK, *supra* note 13, at 20.

⁴⁵ *Id.* at 18. Based upon National Venture Capital Association Yearbook data for 2005, Silicon Valley attracted 32% and New England attracted 11% of the total venture capital funding. *Id.* at 19; see also Erber, *supra* note 42, at 12. In addition to information technology, the New England area also is “a strong innovation area for biotechnology and medical devices.” *Id.* at 14.

⁴⁶ Erber, *supra* note 42, at 12-13.

⁴⁷ *Id.* at 12, 14. The top seven regions in 2008 were: Silicon Valley (39.3%); New England (11.1%);

cannot be overstated, as “innovators and start-up entrepreneurs all over the world . . . relocate their activities to [regional] centres to have better access to venture capital markets” than they have in their own counties and states.⁴⁸

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 regions 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 the region in order to survive a major recession.⁴⁹ 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.⁵⁰

II. 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.⁵¹ 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.⁵² 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.⁵³ In addition, some states have undertaken “a purely facilitative role by supporting networks of individual investors . . . and venture capital fairs.”⁵⁴ Under

LA/Orange County (7.5%); NY Metro (6.8%); Northwest (4.6%); Midwest (4.4%); and San Diego (4.4%). *Id.* at 15.

⁴⁸ *Id.* at 16.

⁴⁹ *See id.* at 12-16.

⁵⁰ *Id.*

⁵¹ Barkley, *supra* note 2, at 351. “[E]arly programs includ[ed] the Massachusetts Capital Resource Company, the Connecticut Product Development Corporation, and Kansas Venture Capital, Inc.” *Id.*

⁵² *Id.* at 350-51.

⁵³ *Id.* at 351.

⁵⁴ *Id.*

this scheme, the state avoids the obligation of managing the investments of the fund, leaving these responsibilities up to experienced fund managers.⁵⁵ In this way, the state is able to limit both its financial liability and risk.⁵⁶

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.⁵⁷ State government officials who seek reelection are typically neither willing to take on the political risk from lackluster returns or losses, nor 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 his or her 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.⁵⁸

At one extreme, publicly funded and managed programs allow for greater governmental control by the targeting of investment decisions, allowing the state to focus its investments on specific "economic development objectives."⁵⁹ These state-sponsored venture capital programs have been met with mixed results.⁶⁰ The programs are most often managed by employees of state agencies or quasi-public

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ See generally Yochanan Shachmurove, *Economic Geography, Venture Capital and Focal Points of Entrepreneurial Activity* (Penn. Inst. for Econ. Res., Working Paper No. 09-032, Aug. 2009), available at <http://ssrn.com/abstract=1460823> (This study utilizes 30 years of data from 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 investments. The results show that despite popular beliefs, returns on investment are only adequate given their substantial risk.).

⁵⁸ See Barkley, *supra* note 2, at 351.

⁵⁹ *Id.*

⁶⁰ *Id.* The success of state programs is "measured in terms of financial returns, economic development impacts, and sustained political support." *Id.*

organizations.⁶¹ The individuals responsible for making investment decisions and providing oversight are typically “appointed by the [g]overnor.”⁶² These funds are most often “capitalized [by public funds generated from] [s]tate appropriations or bond sales.”⁶³ 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 must comply with the state’s economic development agenda.⁶⁴

The primary advantage of publicly funded, publicly managed funds is their ability to direct funding towards particular policy objectives or industries.⁶⁵ This allows for economic and social impact to be considered during the investment decision-making process.⁶⁶ However, these funds can also face substantial “[p]olitical pressure to make investments in specific” areas of the state or in specific businesses that otherwise might not be considered good investments.⁶⁷ In addition, publicly managed firms may not be able to attract the most qualified or competent fund managers.⁶⁸ 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.⁶⁹ Moreover, under this management structure, the state also assumes greater direct “responsibility for funding the program as well as for any financial losses or gains that [might] occur.”⁷⁰ Such programs have also been criticized for inadequately financing “capitalization and management,” the existence of “government regulations that impeded fund

⁶¹ David L. Barkley & Deborah M. Markley, *Nontraditional Sources of Venture Capital for Rural America*, 16 RURAL AMERICA 19, 21 (2001), available at <http://www.ers.usda.gov/publications/ruralamerica/ra161/ra161d.pdf>.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* at 24.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ Barkley, *supra* note 2, at 351.

operations, and poor financial returns on fund investments.”⁷¹ 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.⁷² This may limit the fund’s ability to invest in a broader range of opportunities and leverage private sector venture capital.⁷³

Like publicly funded, publicly managed funds, publicly funded but privately managed funds generally receive the bulk of their capitalization from public sources.⁷⁴ However, unlike their publicly managed counterparts, privately managed funds are organized with a somewhat different purpose; typically, the purpose of these funds is 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.⁷⁵ These funds tend to focus more on maximizing profits and less on social or economic development objectives.⁷⁶ Although the state “sacrifices [direct management] control over investment management decisions,” it gains “more limited financial risk” and may receive better economic returns.⁷⁷

The structure of capitalization of this type of fund has varied among state programs.⁷⁸ Some have obtained state funding with a requirement for a private match or provided additional inducements to encourage private investment.⁷⁹ 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.⁸⁰ Although publicly funded, privately managed funds have many advantages over their publicly managed counterparts, they are not

⁷¹ *Id.*

⁷² Barkley & Markley, *supra* note 61, at 24-25.

⁷³ *Id.* at 25.

⁷⁴ *Id.* at 22.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ *Id.*

⁷⁹ *Id.*

⁸⁰ *Id.*

without disadvantages.⁸¹ While these funds are less subject to political pressure, are better positioned to attract experienced managers, and have greater leverage to obtain private capital investments, the state's economic development objectives may be overlooked because management's primary focus is on maximizing returns.⁸²

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.⁸³ Public funding "should be provided in one lump sum as opposed to annual appropriations over a period of time" to ensure effective program buy-in and continuity.⁸⁴ 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.⁸⁵ 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.⁸⁶ Furthermore, capital venture investments may experience failures before successes occur.⁸⁷ Such failures can have a "cooling [effect on the] legislative support for future appropriations," jeopardizing both current and future investment decisions.⁸⁸

A third type of state-sponsored venture capital program provides incentives, often in the form of tax credits, to encourage private venture capital investments.⁸⁹ In this form of venture capital legislation, the state's control is limited to the

⁸¹ *Id.*

⁸² *Id.* at 26.

⁸³ DAVID L. BARKLEY ET AL., RURAL POL'Y RES. INST., ESTABLISHING NONTRADITIONAL VENTURE CAPITAL INSTITUTIONS: THE DECISION MAKING PROCESS 6, Rural Policy Research Institute5 (2001), *available at* <http://policy.rutgers.edu/faculty/rubin/Establishing%20nontraditional%20vc%20institutions%20part%20c%202001.pdf>.

⁸⁴ *Id.* at 12.

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.*

⁸⁹ Barkley, *supra* note 2, at 351.

restrictions outlined in the enabling legislation, and the state does not always share in the direct financial gains that these investments may achieve.⁹⁰ These programs have been referred to as Certified Capital Companies (“CAPCOs”).⁹¹

“The first CAPCO legislation was passed in Louisiana” in 1983.⁹² Since that time, a number of other states have adopted similar legislation.⁹³ Under the typical CAPCO enabling legislation, the state offers tax credits to insurance companies in return for “certified investments” in CAPCOs.⁹⁴ The tax credits are available to offset future tax obligations that insurance companies pay on premiums collected in the state.⁹⁵ Thus insurance companies are basically investing in a guaranteed security rather than a risky investment. In addition, these tax credits are “usually transferable or saleable by the insurance companies.”⁹⁶

In order to build upon and enhance the existing venture capital infrastructure

⁹⁰ The state would still enjoy potential increase in state tax revenues, which would result from the increased economic activity generated by the businesses in which the investments were made.

⁹¹ Barkley, *supra* note 2, at 350.

⁹² *Id.* at 352.

⁹³ *Id.* Other states that have adopted the CAPCO model are: Missouri, New York, Wisconsin, Florida, Kansas, Texas, Vermont, Colorado, Alabama, and the District of Columbia. *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.* 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. Velislava Grudkova & Michael L. Benton, *CAPCO Programs Offer Tax Credits to Attract Venture Capital for Small Businesses*, THE JOURNAL FOR MULTISTATE TAXATION & INCENTIVES 16 (June 2002).

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. *Id.*

⁹⁶ Barkley, *supra* note 2, at 352.

in the state, CAPCOs are generally selected from well established private sector venture capital funds that become certified with the state.⁹⁷ Certification requirements established by the state include, among other things, minimum capitalization requirements, investment experience requirements, and the “establishment of an in-state office.”⁹⁸ Once the funds are selected and certified as CAPCOs, they must meet certain established investment criteria and invest 100% of the certified capital before any of the investment gains can be distributed to the partners.⁹⁹ 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.¹⁰⁰

The state enabling legislation also commonly creates “a means for CAPCOs to decertify, either voluntarily or as a result of noncompliance with the rules” established for their operation.¹⁰¹ Generally, “voluntary decertification occurs either when a CAPCO fails to meet requirements for raising certified capital or when a CAPCO has met the investment requirement under the legislation.”¹⁰² 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.¹⁰³ The CAPCO may then choose to decertify, and consequently make distributions of its profits.¹⁰⁴

CAPCOs must make investments in “qualified businesses” as defined in the enabling legislation.¹⁰⁵ In defining “qualified businesses,” the state is essentially targeting the types of businesses it wants to support in order to meet its “economic

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.* at 365 n.4.

¹⁰² *Id.*

¹⁰³ *See, e.g.*, State of Louisiana Legislative Auditor, Department of Economic Development Office of Financial Institutions A Review of the Louisiana CAPCO Program 33 (2001).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.*

development objectives.”¹⁰⁶ Generally, qualified businesses must be small, located and operated within the state, with most of its employees residing in the state.¹⁰⁷ Once again, depending on the states’ particular economic development objectives, certain sectors of the economy are specifically excluded from participating as qualified businesses.¹⁰⁸ CAPCO investments must be made “in qualified businesses to ensure the availability of tax credits for insurance company investors.”¹⁰⁹

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.¹¹⁰ 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.¹¹¹ Some states have also incorporated provisions in their legislation which would allow them to participate directly in the investment returns of the CAPCO investments in addition to the anticipated increase in future tax revenues.¹¹²

State governments provide oversight of CAPCOs by requiring that they

¹⁰⁶ *Id.*

¹⁰⁷ Grudkova & Benton, *supra* note 95, at 46. The Small Business Administration definition of a small business varies by major industry group, but generally includes businesses of fewer than 100 hundred employees for manufacturing and less than \$5 million in annual sales for retail trade and services. *Id.* at 47.

¹⁰⁸ *Id.* at 46-47.

¹⁰⁹ Barkley, *supra* note 2, at 352.

¹¹⁰ *Id.* at 355.

¹¹¹ TUCKER ADAMS, GROWTH CAPITAL ALLIANCE, THE COLORADO CAPCO PROGRAM: AN ANALYSIS 22 (2003), <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 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.*

¹¹² Barkley, *supra* note 2, at 355.

report on an annual basis to designated regulatory authorities.¹¹³ 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.¹¹⁴ 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.¹¹⁵ 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.¹¹⁶

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, existence of “government regulations that impede[] fund operations, and poor financial returns on fund investments.”¹¹⁷ CAPCO programs, however, are not nearly as susceptible to such criticisms.¹¹⁸ First, because CAPCOs are capitalized through the use of tax credits, they “do not require current state budget expenditures or bond sales.”¹¹⁹ The actual cost of the tax credits to the state “is reduced by the allocation of tax credits over time.”¹²⁰ Funding CAPCOs with tax credits and spreading tax credits over 10 years make CAPCOs an attractive alternative when

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 351, 355. This includes both publicly funded and publicly managed and publicly funded and privately managed venture capital funds. *Id.*

¹¹⁸ *Id.* at 360.

¹¹⁹ *Id.* 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.

[T]he cost to the state [for CAPCOs] is the present value of future tax revenues lost due to tax credits over [a] 10 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 10 years of tax credits than with a program funded with one lump sum payment.

Id. at 361.

¹²⁰ *Id.* at 360.

compared to programs that require current expenditures of debt.¹²¹ 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.”¹²²

Second, traditional publicly funded and managed venture capital programs are commonly constrained by state pay regulations and are limited in how much they can compensate public fund managers.¹²³ 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.¹²⁴ CAPCOs, on the other hand, are more able to attract “experienced fund managers because of higher salary, profit sharing, and benefit offerings.”¹²⁵

Third, with respect to publicly managed venture capital funds, there is a perception of, if not the potential for, political interference with investment decisions.¹²⁶ Similarly, with publicly funded and privately managed funds, “there is the potential for political interference in the selection of the private funds” that will manage the monies.¹²⁷ The CAPCO management structure, which limits “the state’s role . . . to certifying the capital companies,” reduces the “political pressure to place state monies in specific private venture capital firms.”¹²⁸ “The participating insurance companies individually select in which of the CAPCOs to place their funds,” which diminishes any political pressure “to make investments in specific businesses.”¹²⁹ Because the CAPCO is insulated from political influence, private venture funds are more inclined to co-invest with privately managed CAPCOs, thus increasing the fund’s ability to participate in syndicated deals and leverage its certified

¹²¹ *See id.*

¹²² *Id.*

¹²³ *Id.* at 361.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.* at 360-61.

¹²⁷ *Id.* at 360.

¹²⁸ *Id.* at 360-61.

¹²⁹ *Id.* at 361.

capital.¹³⁰

III. THE TNINVESTCO PROGRAM

The Tennessee Small Business Investment Company Credit Act (the “Act”)¹³¹ is similar in many respects to the legislation that created Certified Capital Company programs in a number of other states. The Act creates six certified venture capital funds, each referred to as a “TNInvestco,”¹³² which have been authorized to receive a total of \$120 million in investment tax credits to be offered to insurance companies (“Participating Investors”) in exchange for capital commitments in the TNInvestco.¹³³ 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.¹³⁴

The Act provides that only \$14 million in capital investments will be necessary to secure an investment tax credit allocation of \$20 million.¹³⁵ Because of the relatively small capital contribution necessary to secure a much larger tax credit, a potential exists for a substantial return on investment resulting from the difference between the present value of a Participating Investor’s capital contribution and that of the corresponding investment tax credits. The appeal of this potential return may be reduced by such factors as risk and discount rate because the contributions are frontloaded, meaning the benefits of the credits will not be had until several years

¹³⁰ *Id.*

¹³¹ TENN. CODE ANN. §§ 4-28-101 to -112 (Supp. 2009).

¹³² *Id.* 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.

¹³³ *See id.* § 4-28-105. Under present Tennessee law, insurance companies are generally subject to a tax of 2.5% “on gross premiums paid by or for policyholders residing in the state or on property located in [the] state.” TENN. CODE ANN. § 56-4-205(a)(1)(A) (2008). “Domestic and foreign life insurance companies . . . pay a tax equal to [1.75%] of gross premiums received from citizens of and residents of [Tennessee].” *Id.*

¹³⁴ TENN. CODE ANN. § 4-28-103(a). No insurance company, however, may receive more than \$30 million of the total \$120 million tax credit. *See id.* § 4-28-105(d).

¹³⁵ *Id.* §§ 4-28-102(4), -105(b).

following the corresponding capital contribution.¹³⁶ Nevertheless, other states have proven successful in obtaining capital contributions from participating investors under legislation similar in many respects to that of Tennessee's.¹³⁷

After securing capital contributions, the TNInvestcos are then required to use the Participating Investor's pledged capital to fund qualifying Tennessee small businesses following a strict performance schedule.¹³⁸ A TNInvestco must first obtain a determination from the Tennessee Department of Economic and Community Development ("DECD") that a prospective investment is eligible as a qualified investment.¹³⁹ Generally, a qualified investment is an investment in a business that is headquartered in and has its principal business operations in the state; has 100 or less employees; has at least 60% of its employees located in Tennessee; is not engaged in a restricted business as defined in the Act; and has no financial relationship to the TNInvestco prior to the TNInvestco's investment in the business.¹⁴⁰ An investment will be determined to constitute a qualified investment if the DECD fails to provide a written notification stating whether or not the prospective investment meets the requirements of the Act within 10 business days.¹⁴¹ Investments that do not meet the criteria listed above may nevertheless be considered a qualified investment if the DECD determines that the "investment will further state economic development."¹⁴²

The Act also requires that 50% of the base investment (\$14 million for each \$20 million investment tax credit allocation) must be invested in qualifying investments within two years, 70% within three, 80% within four, and 90% within the first six years.¹⁴³ Every dollar invested in a qualifying business that constitutes a

¹³⁶ See *id.* § 4-28-103 (describing delayed tax credit eligibility for Participating Investors).

¹³⁷ See Barkley, *supra* note 2, at 365 n.3 (noting that states with CAPCO programs typically have little difficulty obtaining capital contributions from insurance companies in exchange for tax credits).

¹³⁸ *Id.* §§ 4-28-102(10), (11), 4-28-106(a)(1).

¹³⁹ *Id.* § 4-28-106(b). In any event, "a qualified TNInvestco may not invest more than [15%]" of the capital received from Participating Investors "in any one qualified business without the specific approval of the [DECD]." *Id.* § 4-28-106(d).

¹⁴⁰ *Id.* § 3, § 4-28-102(10)(A)(iii)-(iv).

¹⁴¹ *Id.* § 4-28-106(b).

¹⁴² *Id.*

¹⁴³ *Id.* § 4-26-106(a). All excess capital held by the TNInvestco (i.e., that which exceeds the percentage

seed or other early stage investment will count as a three-dollar investment for the purposes of meeting the performance requirements of this provision.¹⁴⁴ By year six, however, no more than 25% of the base investment amount can be invested in seed or early stage ventures, or the TNInvestco will forfeit any un-invested capital to the state.¹⁴⁵

A TNInvestco must provide notice to the DECD of its compliance with the performance measures listed above.¹⁴⁶ If the DECD does not notify the TNInvestco within 60 days from the filing of these reporting requirements that it is non-compliant, the TNInvestco “shall be deemed to have met” the legislative requirements.¹⁴⁷ “Failure to meet [these] performance measures . . . [will] result in a . . . [substantial] penalty” of \$250,000 per calendar year of violation.¹⁴⁸

Participation in the program essentially consists of two steps. First, a prospective fund must apply to become a TNInvestco.¹⁴⁹ The DECD began accepting applications from prospective funds seeking to be classified as TNInvestcos on August 1, 2009.¹⁵⁰ By October 1, 2009, all applicants desiring to participate in the program were to have submitted their applications, including a nonrefundable fee of \$7,500 and an audited balance sheet showing the fund “has an

requirements in the investment schedule) may be invested as the “TNInvestco . . . deems appropriate.” *Id.* § 4-28-106(c).

¹⁴⁴ *Id.* § 4-28-102(12). A seed or early stage investment is generally a qualified business whose “product or service [is] in testing or pilot production.” *Id.* § 4-28-102(14). Effectively reducing performance requirements for investments creates an incentive for TNInvestcos to invest solely in seed or other early stage businesses in order to more easily meet the performance schedule and secure the corresponding investment tax credits, effectively using the least amount of capital possible. If left unrestricted, less than \$5 million would be needed to meet the investment schedule and secure the corresponding \$20 million dollar investment tax credit for a TNInvestco’s Participating Investors. Because of the potential for this type of abuse, the Act limits any investments in seed or other early stage investments beyond the sixth year of the program to no more than 25% of the overall investment. *Id.* § 4-28-106(a)(1)(D).

¹⁴⁵ *Id.* § 4-28-106(a)(1)(D).

¹⁴⁶ *Id.* § 4-28-110(c).

¹⁴⁷ *Id.*

¹⁴⁸ *Id.* § 4-28-106(a)(2).

¹⁴⁹ *See id.* at § 5, § 4-28-104(b)(1).

¹⁵⁰ *Id.* at § 5§ 4-28-104(e).

equity capitalization of [\$500,000] or more in the form of unencumbered cash, marketable securities, or other liquid assets.”¹⁵¹ Applicants were notified within 30 days following the submission of their applications as to whether or not they had been approved as a TNInvestco.¹⁵²

Second, the approved TNInvestco had to apply for an allocation of investment tax credits to be used in attracting capital investments from Participating Investors.¹⁵³ Allocation of investment tax credits are made in six \$20 million allotments, each to a selected TNInvestco.¹⁵⁴ Selection is based on each TNInvestco’s strength of application after examination of various criteria, such as whether “an applicant has at least [two] investment managers with at least [five] years of investment experience; a principal office within the state for the preceding five years or “has at least [five] years of experience in . . . primarily” in-state investing; a strong plan to promote economic growth by investing in early stage or seed companies; and a “demonstrated ability” to manage the fund and provide necessary assistance to entrepreneurs.¹⁵⁵

The investment tax credit application must also contain statements attesting to the TNInvestco’s ability to “obtain the required investment commitments” of at least \$14 million if seeking one \$20 million investment tax credit allocation or \$28 million if seeking two.¹⁵⁶ In no event may a TNInvestco apply for more than two \$20 million credit allocations.¹⁵⁷ Selection of the TNInvestcos to receive investment

¹⁵¹ *Id.* §§ 4-28-104(b)(2)-(3), (e).

¹⁵² *Id.* § 4-28-104(d). The six initial venture capital firms selected to participate in the TNInvestco program are: Tennessee Community Ventures Fund, LLC, Nashville; XMi High Growth Development Fund, LLC, Nashville; Limestone Fund, LLC, Nashville; Tri-Star Technology Fund, LLC, Brentwood; Innova Fund II, LP, Memphis; Council & Enhanced Tennessee Fund, LLC, Nashville. J.R. Lind and E. Thomas Wood, *The Lucky Six: TNInvestco Winners Chosen*, NASHVILLE POST, Nov. 5, 2009, available at http://www.nashvillepost.com/news/2009/11/5/the_lucky_six_tninvestco_winners_chosen. The two alternate funds selected are Solidus-TNInvestco, LLC, Nashville, and Tennessee Angel Fund, Nashville. These were chosen from 25 initial applicants and a finalist list of 10. *Id.*

¹⁵³ See TENN. CODE ANN. § 4-28-105.

¹⁵⁴ *Id.* § 4-28-105(d).

¹⁵⁵ *Id.* § 6, § 4-28-105(c)(1)(A).

¹⁵⁶ *Id.* § 6, § 4-28-105(b).

¹⁵⁷ *Id.* § 4-28-105(d).

tax credit allocations falls within the sole discretion of the Commissioners of the DECD and the Tennessee Department of Revenue.¹⁵⁸

“Each [approved] TNInvestco . . . submit[ted] irrevocable investment commitments from [P]articipating [I]nvestors” equal to \$14 million for each \$20 million tax credit allocation prior to November 30, 2009.¹⁵⁹ Applicants likely began seeking investment commitments from insurance companies prior to officially receiving any investment tax credit allocations because the DECD’s deadline to notify those approved for investment tax credit allocations was December 31, 2009, only one month after the date on which TNInvestcos were required to obtain irrevocable commitments from Participating Investors.¹⁶⁰

Most significant for potential investors, the Act places considerable restrictions on certain distributions from a TNInvestco.¹⁶¹ Most notably, the Act distinguishes between qualified distributions, which may be made at any time, and all other distributions, which are subject to various restrictions and are subject to a profit-share percentage.¹⁶² The legislation defines a qualified distribution as a payment made by a TNInvestco, provided the payment is not made to a Participating Investor, its affiliate, or to the state for the reimbursement of the following fees and expenses: formation and organizational expenses not to exceed \$125,000; annual management fees of up to 2% of the base investment amount for years one through four, and 2% of the lesser of the base investment amount or the TNInvestco’s qualified investments thereafter; fees for ongoing professional services not to exceed \$50,000 per year; and federal and state taxes associated with the ownership, management, or operation of the TNInvestco.¹⁶³

¹⁵⁸ *Id.* § 4-28-105(c)(2).

¹⁵⁹ *Id.* at § 6, § 4-28-105(b). The securitization amount can be greater, but it cannot be less than \$14 million. Failure to raise the required capital will result in a \$50,000 penalty. It has been reported that the all six TNInvestcos “have met or exceeded their requirement to secure at least \$84 million in aggregate participation commitments from” Participating Investors (insurance companies). *See* Milt Capps, *TNInvestco Engine Warms-Up, as Funds Pass Crucial Tests*, VENTURE NASHVILLE CONNECTIONS, Dec. 2, 2009, <http://www.venturenashville.com/tinvestco-engine-warms-up-as-funds-pass-crucial-test-cms-409>.

¹⁶⁰ TENN. CODE ANN. § 4-28-105(b), (e).

¹⁶¹ *Id.* § 4-28-108.

¹⁶² *Id.* §§ 4-28-102(9), 108, 109.

¹⁶³ *Id.* § 4-28-102(11). As an aside, § 4-28-102(11)(E) contemplates payments to Participating

In contrast, distributions other than qualified distributions can only be made after the seventh anniversary of the establishment of the TNInvestco fund.¹⁶⁴ These distributions are essentially investment returns, which include both profits and a portion of the base investment amount.¹⁶⁵ If a “non-qualified distribution”¹⁶⁶ is made, the distribution will be subject to a 50% profit-share with the state of Tennessee.¹⁶⁷ For example, any repayment of capital to participating investors would fall under the definition of a non-qualified distribution, and would thus be subject to a 50% profit-share with the state. No provision of the Act prohibits a repayment of capital to the Participating Investor, even though testimony given during floor debates on the Act, as well as the language of the Act itself, suggests that the legislature expects Participating Investors to earn a return on their investment primarily through the difference between the present value of the capital contributed by the Participating Investor and that of the corresponding tax credits allocated to the Participating Investor.¹⁶⁸ As such, there is nothing that would prohibit a Participating Investor from seeking to reach an agreement with the TNInvestco, whereby it would receive a guaranteed return of a portion of its investment or participate in a percentage of the profits earned prior to submitting its irrevocable

Investors as a qualified distribution. *Id.* However, this provision directly contradicts the first sentence of Section 3(11), which expressly provides that distributions made to Participating Investors or their affiliates are *not* qualified distributions. *See id.* § 4-28-102(11). Legislative history does not shed light on what the Tennessee Legislature sought to accomplish in these provisions, but it seems as if the two conflicting provisions cannot be squared in any meaningful way.

¹⁶⁴ *Id.* § 4-28-109(b).

¹⁶⁵ *Id.* (“[I]nvestment returns (profits and the portion of the base investment amount) may be distributed as liquidity permits; provided, that no more than twenty-five percent (25%) of the TNInvestco’s base amount may be distributed in any one (1) year until the end of the investment period, at which time all of the fund’s proceeds may be distributed as liquidity permits.”).

¹⁶⁶ Although the Act does not use the term non-qualified distribution, for purposes of clarity and to distinguish them from qualified distributions, all distributions other than qualified distributions or repayments of capital contributions by the TNInvestco’s equity owners who are not Participating Investors will hereinafter be referred to as “non-qualified distributions.”

¹⁶⁷ *Id.* § 4-28-109(a)(1). While various other states have enacted legislation directed at stimulating venture capital into small businesses of a particular state, only a few have adopted a profit sharing provision, whereby the state participates in profit distributions from their investment. *See* Barkley, *supra* note 2, at 353-54 (showing only four of 13 states with state-passed and state-proposed CAPCO legislation had state profit-sharing provisions.).

¹⁶⁸ *Id.* §§ 4-28-102(4), -105(b).

commitment of capital.

It is important to note that the profit-share percentage does not apply to non-qualified distributions representing repayments of capital contributions to equity investors.¹⁶⁹ This allows any equity investor who is not a Participating Investor to recoup capital contributions without the restrictions of the profit-share percentage.¹⁷⁰ As a result, TNInvestco fund managers can give priority to equity investors, essentially assuring the safety of their capital contribution, before the state can enjoy any returns on its investment.¹⁷¹ However, once the equity investor's capital contribution has been recaptured, any remaining non-qualified distributions would be subject to the profit-share percentage.¹⁷²

Beyond the context of the profit-share percentage, the Act also imposes restrictions on when non-qualified distributions can be made.¹⁷³ While qualified distributions may be made at any time, non-qualified distributions may only be made annually or after certain liquidating events as designated by the TNInvestco.¹⁷⁴ Any non-qualified distributions made prior to year seven may only be made to the extent the distribution does not reduce the total investment below the base investment amount.¹⁷⁵ Beginning in year seven, distributions may then be made notwithstanding any reduction in the base investment amount, but in no event may the distribution constitute more than 25% of the TNInvestco's base amount for that year.¹⁷⁶ After December 31, 2019, however, non-qualified distributions may be made with no restrictions other than the applicable profit-share percentage.¹⁷⁷

In summary, the Act provides various incentives for insurance companies

¹⁶⁹ See TENN. CODE ANN. § 4-28-109(a)(1); *Hearing Before the H. Calendar & Rules Comm.*, 106th Gen. Assem. (June 17, 2009); available at <http://wapp.capitol.tn.gov/apps/BillInfo/Default.aspx?BillNumber=HB2085>.

¹⁷⁰ See *id.*

¹⁷¹ See *id.*

¹⁷² See *id.*

¹⁷³ See *id.* § 4-28-108.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.* § 4-28-109(b).

¹⁷⁶ *Id.*

¹⁷⁷ *Id.* § 4-28-109(a)(1).

and venture capital funds alike to participate in the TNInvestco program. On the other hand, the Act's numerous restrictions, fines, and profit-sharing provisions may create more risk and reduce the potential for reward, creating various deterrents for the potential investor. However, these restrictions were incorporated in the TNInvestco legislation in order to improve upon the shortcomings of the CAPCO model, allowing the state to become a true partner in the venture capital investment process.

IV. IMPROVING UPON THE CAPCO MODEL

It has been over 25 years since the first CAPCO legislation was passed.¹⁷⁸ During this time similar legislation has been implemented in nine additional states and the District of Columbia.¹⁷⁹ 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.

The expansion of CAPCO programs since the late 1990s was due in large part to the lobbying efforts of a "relatively concentrated CAPCO industry"—CAPCO fund management groups.¹⁸⁰ "Four CAPCO fund management groups . . . control the bulk of the industry across the United States."¹⁸¹ In fact, three of these firms —

¹⁷⁸ DANIEL SANDLER, STATE SPONSORED VENTURE CAPITAL: ARE CAPCOS A SOLUTION OR A PROBLEM? 1 (2004), [http://www.lippercurrent.com/dcn/lc.nsf/b4967bfe087a19e486257567008208d1/fc2ba2d4c077d83c86256ebb0075e778/\\$FILE/CAPCO%20article_v2.doc](http://www.lippercurrent.com/dcn/lc.nsf/b4967bfe087a19e486257567008208d1/fc2ba2d4c077d83c86256ebb0075e778/$FILE/CAPCO%20article_v2.doc).

¹⁷⁹ See note 51, *supra*.

¹⁸⁰ Daniel Sandler, *State Venture Capital*, January 2006, at 7, available at www.lavca.org/lavca/resdb.nsf/0/B222D017972370CD8625712400761BC8/FILE/Sandler%20state%20venture%20capital.pdf.¹⁸⁰ DANIEL SANDLER, STATE VENTURE CAPITAL 7 (2006), [www.lavca.org/lavca/resdb.nsf/cbce83d7e371c22586256fc700811a07/b222d017972370cd8625712400761bc8/\\$FILE/Sandler.%20state%20venture%20capital.pdf](http://www.lavca.org/lavca/resdb.nsf/cbce83d7e371c22586256fc700811a07/b222d017972370cd8625712400761bc8/$FILE/Sandler.%20state%20venture%20capital.pdf); SANDLER, *supra* note 178, at 1.

¹⁸¹ SANDLER, *supra* note 180, at 7. The four major CAPCO fund management groups are Advantage Capital, Enhanced Capital, Stonehenge Capital, and Newtek. SANDLER, *supra* note 178, at 1. These four fund management groups "accounted for approximately 80 percent of the \$1.65 billion of the

Advantage Capital Partners, Enhanced Capital Partners, and Stonehenge Capital Company – led the lobbying efforts in Tennessee in an attempt to get their version of CAPCO legislation passed.¹⁸² However, state legislators led by the Bredesen Administration “settled on a model quite different from those” proposed by CAPCO fund management groups.¹⁸³ In fact, despite initial concerns that these management groups would have undue influence on the TNInvestco selection process, only one of the selected TNInvestcos is affiliated with a CAPCO management group that led the lobbying efforts in the legislature.¹⁸⁴

One criticism of CAPCO programs is that they enrich fund management groups while doing little to support early-stage entrepreneurship within the state.¹⁸⁵ In fact, CAPCO programs have been accused of actually hurting the state venture capital industry.¹⁸⁶ This criticism originates from the fact that CAPCO management groups have existing relationships with insurance companies through CAPCO programs in other states.¹⁸⁷ 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.¹⁸⁸ Additionally, because CAPCOs have “cost advantage[s] in raising

total state tax credits granted between 1986 and 2001 [in all CAPCO programs] across the United States.” *See id.*

¹⁸² Milt Capps, *State Venture-Capital Incentive Gains Traction in Gen. Assembly*, VENTURE NASHVILLE CONNECTIONS, May 1, 2009, <http://www.venturenashville.com/state-venture-capital-incentive-gains-traction-in-gen-assembly-cms-270>.

¹⁸³ E. Thomas Wood, *Finalists Named for State's \$120M Venture Pool*, NASHVILLEPOST.COM, Oct. 7, 2009, http://www.nashvillepost.com/news/2009/10/7/finalists_named_for_states_120m_venture_pool.

¹⁸⁴ *Id.* New York City based Enhanced Capital teamed with Council Ventures, a Nashville venture capital fund, to form Council & Enhanced Tennessee Fund. *Id.* “Ventures including the other two leading [CAPCO] firms, Advantage Capital Partners and Stonehenge Capital Co., failed to make the” shortlist of finalists. *Id.*

¹⁸⁵ Sandler, *supra* note 178, at 5.

¹⁸⁶ Julia S. Rubin, Testimony on the Washington DC CAPCO Program before Small Business Committee, District of Columbia City Council 4 (Apr. 3, 2009), *available at* <http://policy.rutgers.edu/faculty/rubin/CAPCO%20testimony.pdf>.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

capital,” they often “offer more favorable investment terms to [their] portfolio companies.”¹⁸⁹ This may result in existing out-of-state fund management groups “crowd[ing] out” other in-state venture capital providers and “discourage[ing] new venture capital formation in the state.”¹⁹⁰

The TNInvestco program overcomes this shortcoming by giving a preference to venture capital funds with a well established history of investing in Tennessee small businesses.¹⁹¹ 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.”¹⁹² For those applicants that did not meet these criteria, an opportunity was afforded to enter into a joint venture with applicants meeting these standards.¹⁹³ Moreover, this requirement is included as one of the four major factors in the TNInvestco Evaluation Matrix, upon which the overall strength of the TNInvestco applications is judged.¹⁹⁴

Evaluations of other CAPCO programs reveal that they tend to make few seed or startup investments.¹⁹⁵ This is because their primary focus is on “maximiz[ing] profitability within the parameters” outlined in the state enabling

¹⁸⁹ Barkley, *supra* note 2, at 363.

¹⁹⁰ *Id.*

¹⁹¹ See TENN. CODE ANN. § 4-28-105(c)(1)(A)(ii) (Supp. 2009); Barkley, *supra* note 2, at 363.

¹⁹² TENN. CODE ANN. § 4-28-105(c)(1)(A)(ii).

¹⁹³ *Id.* § 48-28-105(c)(1)(B).

¹⁹⁴ *Id.* § 4-28-105; TENNESSEE DEPARTMENT OF ECONOMIC AND COMMUNITY DEVELOPMENT, TNINVESTCO EVALUATION MATRIX, <http://tennessee.gov/ecd/tinvestco/pdf/matrixfinal.xls>. The Evaluation Matrix contains four major sections: (1) Experience (“The applicant has at least two (2) investment managers with five (5) or more years investment experience.”) (25 points); (2) Tennessee Experience and Ownership (“The applicant has been based, as defined by having a principal office, in the state of Tennessee for at least five (5) years or has at least five (5) years of experience in investing primarily in Tennessee domiciled companies.”) (15 points); (3) Strategy (“The applicant’s proposed investment strategy for achieving transformational economic development outcomes through focused investments of capital in seed or early stage companies with high-growth potential.”) (40 points); (4) Credibility (“The applicant’s demonstrated ability to lead investment rounds, advise and mentor entrepreneurs, and facilitate follow-on investments.”) (20 points). *Id.*

¹⁹⁵ Barkley, *supra* note 2, at 362.

legislation.¹⁹⁶ As such, to the greatest extent possible, they try to make later stage investments, which carry lower risk and present the best potential for a quick return on investment.¹⁹⁷ In response, the Act 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.¹⁹⁸ The TNInvestco Evaluation Matrix awards a maximum 40 points for this section, the most of the four evaluation factors used in determining the overall strength of the TNInvestco application.¹⁹⁹

The emphasis placed on seed and early stage financing within the evaluation matrix, however, clearly underscores the importance the Bredesen Administration places on this investment class in contributing to the future of the state's economy.²⁰⁰ Specifically, the Act reinforces this policy through the implementation of its investment performance measures.²⁰¹ 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.²⁰² This encourages TNInvestco fund managers to seek out small business investments, especially during the initial few years of the TNInvestco program, to more easily meet their performance objectives.

Another criticism of CAPCO programs is that, in contrast to their private sector counterparts that profit from exiting carefully chosen investments in high-growth companies, much of the CAPCO profits in other jurisdictions come “from decertifying from the CAPCO program once [the CAPCO has] invested . . . 100 percent of [its] tax credit allocation.”²⁰³ Once this has been achieved, the CAPCOs are able to retain all of the “taxpayer dollars that they do not lose through the

¹⁹⁶ *Id.*

¹⁹⁷ *Id.*

¹⁹⁸ TENN. CODE ANN. § 4-28-106(b).

¹⁹⁹ See TNInvestco Evaluation Matrix, *supra* note 194.

²⁰⁰ See *id.*

²⁰¹ See TENN. CODE ANN. § 4-29-106.

²⁰² *Id.* § 4-28-102(12).

²⁰³ Rubin, *supra* note 186, at 2.

investment process.”²⁰⁴ As a result, there is an “incentive for the CAPCOs . . . to . . . invest the taxpayers’ dollars so as to [e]nsure the fastest and safest” return, and a disincentive to make long-term equity investments in high-growth companies that maximize economic growth and job creation.²⁰⁵

In order to refocus these incentives, the TNInvestco legislation introduces parameters to better control the timing at which the returns on investment can be made to the investors.²⁰⁶ Most importantly, the Act prevents TNInvestcos from making any investment distributions that include the base investment amount until after the seventh year of the fund’s operation.²⁰⁷ Since at least 50% of the base investment amount must be invested within two years of the allocation date, at least half of the base investment amount will be invested for a five-year period before any portion of that amount can be distributed to investors.²⁰⁸ This provision should help provide an equitable balance between the TNInvestco’s desire to rapidly maximize its return on investment and the state’s economic development objective of making longer term investments in high-growth companies.

While “[a]ll state-sponsored venture capital 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 as compared to other state venture capital programs.²⁰⁹ 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

²⁰⁴ *Id.*

²⁰⁵ *Id.*

²⁰⁶ TENN. CODE ANN. § 4-28-109(b); Rubin, *supra* note 186, at 2.

²⁰⁷ TENN. CODE ANN. § 4-28-109(b).

²⁰⁸ *Id.* § 4-28-106(a)(1). In addition, 20% of the base investment will be invested for at least a four-year period, 10% of the base investment will be invested for a at least a three-year period, and 10% of the base investment will be invested for a at least a one-year period, before any non-qualified distributions, which include the base investment amount, can be made. *Id.*

²⁰⁹ Barkley, *supra* note 2, at 261; *see also* Capps, *supra* note 12. *But see* ADAMS, *supra* note 111, at 29. These costs take the form of state appropriations, debt obligations such as the issuance of state bonds, or forgone future tax revenues, necessary to fund the program. Barkley, *supra* note 2, at 361. The revenues are future returns that the state receives either through return from the funds investment or from increased tax revenues obtained both directly and indirectly by the investment in the small business. *Id.*

revenues” exercised ratably over a 10-year period.²¹⁰ In contrast, the cost to the state for alternative investments in private or public venture capital funds is typically “the current lump sum value of the investment.”²¹¹ All things being equal, if investment returns are poor, or if there is a loss, the state will “lose less with a program financed with 10 years of tax credits than with a program funded with one lump sum payment.”²¹² 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.”²¹³ Unlike the other forms of publicly funded programs, the proceeds from CAPCO investments are distributed to the insurance companies or other equity investors and fund managers, and the state does not usually “receive a share of returns from CAPCO investments to help defray program costs.”²¹⁴

From a fiscal standpoint, perhaps the most significant improvement in the Act’s CAPCO model is the requirement that the state receive a portion of any non-qualified distributions made by the TNInvestcos.²¹⁵ 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 funds’ upside potential.²¹⁶ In the event that a TNInvestco is profitable, not only can the state enjoy potential future tax revenues, but it can also repay the treasury for the amount of revenue foregone pursuant to the tax credits allocated to the insurance

²¹⁰ Barkley, *supra* note 2, at 361.

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.* Some states, such as Louisiana and Missouri, have requirements in their enabling legislation that stipulate a share of the CAPCOs liquidating distributions to the state treasury; however, the participation is not sufficient to “eliminate the cost disadvantage of the CAPCO alternative.” *Id.*

²¹⁵ See TENN. CODE ANN. § 4-28-109 (Supp. 2009).

²¹⁶ *Id.* 4-28-102(9). Although this is a significant departure from the CAPCO model, the Act still limits significant downside exposure to both the Participating Investors (insurance companies) and other equity investors who may participate in the fund. The state provides some security to the insurance companies by limiting the downside risk of losses through the future value of the exercised tax credit allowances. The TNInvestco’s other equity owners are allowed to recoup their investment principal prior to the state receiving their fee through the profit share percentage of non-qualified distributions. TENN. CODE ANN. § 4-28-102(9).

industry.²¹⁷

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.²¹⁸ While it is up to the Administration to provide the vision and continued leadership necessary to support effective program implementation, cooperative oversight, and to seek opportunities for continuous program improvement, it is now up to the TNInvestco fund managers to ensure proper implementation by making sound investments and mentoring the selected small businesses through the development and growth process.²¹⁹

V. STRATEGIC PROGRAM AND MANAGEMENT IMPROVEMENTS

The Bredezen Administration has already signaled its intent to ask the legislature to amend the Act by expanding the authorization of \$40 million in tax credits to be distributed to two alternate venture capital firms and to make other technical improvements to the legislation.²²⁰ At least one legislator has called for even further expansion of the TNInvestco program.²²¹ In addition, lobbyists representing venture capital funds continue to attempt to influence legislators in an effort to gain access to future TNInvestco funding.²²² While such enthusiasm for

²¹⁷ *Id.* § 4-28-108.

²¹⁸ *See* Barkley, *supra* note 2, at 355-59.

²¹⁹ *See* METRICK, *supra* note 13, at 9.

²²⁰ Capps, *supra* note 159. The legislation would fund two additional venture capital funds – Tennessee Angel Fund and Solidus TNInvestco – both of which achieved “alternate status” during the TNInvestco selection process. *Id.*

²²¹ Milt Capps, *Senator Ketron Would Broaden TNInvestco and Institute’s Mission*, VENTURE NASHVILLE CONNECTIONS, Dec. 14, 2009, <http://www.venturenashville.com/senator-ketron-would-broaden-tinvestco-and-institutes-mission-cms-417>. Senator Ketron is also on record as wishing “to revive consideration of the TNInvestco candidacy of NEST-TN LLC,” which failed to become a “Qualified TNInvestco” during the selection process. *Id.*

²²² *See* Milt Capps, *Advocates: ‘Protection’ could derail TNInvestco locomotive*, VENTURE NASHVILLE CONNECTIONS, Feb. 22, 2010, <http://www.venturenashville.com/advocates-protection-could-derail-tinvestco-locomotive-cms-468>.

program expansion may be understandable, based upon the experience of similar programs in other states, such enthusiasm should be tempered against the reality that additional future state revenues are being sacrificed on a program in which the state of Tennessee has little, if any, operational experience.²²³

Caption bills have been introduced in both houses of the General Assembly, ostensibly to make technical corrections to the Act.²²⁴ While much greater substance will likely be added during the legislative process, these bills initially focus primarily on providing a clearer definition of the term “qualified distribution;”²²⁵ adding a recapture provision to the Act that will provide the State with the ability to recapture those tax credits from TNInvestcos that have failed to meet their qualified investment objectives;²²⁶ and increasing the percentage of a TNInvestco that an insurance company may own.²²⁷

The caption bill that focuses on redefining the term “qualified distribution” is fairly straight forward, and it aims at providing clarification to the apparent internal contradictions that exist in the legislation.²²⁸ The amendment would eliminate language in the Act that could be interpreted as preventing “qualified distributions” from being made to Participating Investors by a qualified TNInvestco.²²⁹ While such an interpretation is inconsistent with the legislative intent of the Act, the proposed changes will do away with any potential misinterpretation.

In contrast, the amendment that would permit the state to recapture is controversial, and is viewed as an attempt to “revert the TNInvestco program back

²²³ See Barkley, *supra* note 2, at 355-59.

²²⁴ See Milt Capps, *TNInvestco Engine Warms-Up, as Funds Pass Crucial Tests*, VENTURE NASHVILLE CONNECTIONS (Dec. 2, 2009), available at <http://www.venturenashville.com/tinvestco-engine-warms-up-as-funds-pass-crucial-test-cms-409>.

²²⁵ H.B. 3837, 106th Gen. Assem. (Tenn. 2010); SB 3839, 106th Gen. Assem. (Tenn. 2010). See TENN. CODE ANN. § 4-28-102(11) (Supp. 2009).

²²⁶ H.B. 3883, 106th Gen. Assem. (Tenn. 2010); SB 3898, 106th Gen. Assem. (Tenn. 2010). See TENN. CODE ANN. § 4-28-106(a) (Supp. 2009).

²²⁷ H.B. 2927, 106th Gen. Assem. (Tenn. 2010); SB 3049, 106th Gen. Assem. (Tenn. 2010). See TENN. CODE ANN. § 4-28-107(1) (Supp. 2009).

²²⁸ See *supra* note 225 and accompanying text for an example of the confusion that currently exists with the definition of “qualified distribution.”

²²⁹ *Id.*

into [a] more traditional CAPCO program.”²³⁰ While the recapture provision is postured as a mechanism that would protect the public investment, it would have the effect of “substantially increasing the risk of involvement, which would keep some insurers on the sidelines, create deeper discounts on credits sold, and drive down capital realized by TNInvestco funds.”²³¹ This could result in TNInvestco funds seeking to attract insurance-industry participation by having to obtain additional insurance as a means of mitigating the cost of making investors whole if the State recaptured tax credits the fund had sold to investors.²³² This would give the CAPCO funds a competitive advantage over other venture capital funds, because CAPCOs may be “‘large enough to self insure,’ or may gain other advantage through such forms as preexisting insurance relationships, pre-negotiated wrap agreements, or even umbrella wrap policies already in place.”²³³

A similar recapture requirement was eliminated from the legislation as originally enacted, and was replaced with provisions that would impose fines on TNInvestcos that fail to meet the investment criteria outlined in the legislation.²³⁴ Given the fact that this amendment is being proposed on behalf of lobbyists from an out-of-state CAPCO fund, it is difficult to believe that they are “altruistically looking to protect Tennessee taxpayers.”²³⁵

The third proposed amendment increases from 15% to 25% the amount of a TNInvestco that an insurance company or its affiliate may own.²³⁶ This caption bill does not provide any further guidance indicating the purpose of this change, nor has there been any floor debate that would provide an understanding of its intended benefits.

Given the fact that term limits will require much of the executive branch

²³⁰ See Capps, *supra* note 224. Advantage Capital Partners was one of the initial CAPCO funds that lobbied the legislature in an effort to establish a CAPCO program in Tennessee. *Id.* It was not chosen as one of the TNInvestcos during the selection process. See *supra* note 224.

²³¹ *Id.*

²³² *Id.*

²³³ *Id.*

²³⁴ See *id.*

²³⁵ *Id.*

²³⁶ See Capps, *supra* note 224.

leadership instrumental in structuring and implementing the TNInvestco legislation to leave office in 2011, a great deal of the operational experience that has been gained to date will be lost. At this juncture, attention can be best focused on building internal capabilities to help manage program oversight, compliance, and evaluation functions, and by providing support and guidance to the TNInvestcos in achieving the sort of “transformational economic development outcomes” anticipated in the legislation.²³⁷ If there has been any lesson learned from the world financial crisis, it is that a free-market economy works best when financial organizations are monitored and held accountable for their investment decisions. The legislature has given DECD broad authority to monitor the TNInvestcos’ performance and to enforce their compliance with program objectives.²³⁸ Appropriate internal controls need to be established so that DECD’s performance compliance functions are not compromised by the department’s traditional technical service and marketing orientation.²³⁹

From both a strategic planning and program oversight and evaluation perspective, it is essential to know what the extent and nature of venture capital investments is in order to effectively evaluate the future impact of the TNInvestco program. In this regard, there is a wealth of information contained in the MoneyTree Report, a quarterly study of venture capital investment activity in the United States.²⁴⁰ The MoneyTree dataset provides historical information concerning Tennessee venture capital investments by venture capital firm, investee company,

²³⁷ TENN. CODE ANN. § 4-28-105(c)(1)(A)(iii) (Supp. 2009). The law requires each TNInvestco to set out an investment strategy for achieving transformational economic development outcomes through focused investments of capital in seed or early stage companies with high growth potential.” *Id.*

²³⁸ *See* TENN. CODE ANN. §§ 4-28-102 to -112 (Supp. 2009).

²³⁹ STATE OF TENNESSEE DEPARTMENT OF AUDIT ANNUAL REPORT (2008), *Performance Audits*, 8, Available at <http://www.tn.gov/comptroller/sa/pdf/2008annualreport.pdf>. (indicating that the State of Tennessee follows Government Auditing Standards issued by the US Comptroller General). *See generally* UNITED STATES GENERAL ACCOUNTING OFFICE, STANDARDS FOR INTERNAL CONTROL IN THE FEDERAL GOVERNMENT (1999) available at <http://www.gao.gov/archive/1999/ai99021p.pdf>.

²⁴⁰ PRICEWATERHOUSECOOPERS, GLOBAL INSIGHTS AND SOLUTIONS: MONEY TREE SURVEY REPORT, <https://www.pwcmoneytree.com/MTPublic/ns/index.jsp>. The MoneyTree Report is a product of “a collaboration between PricewaterhouseCoopers and the National Venture Capital Association based upon data from Thomson Reuters,” and “it is the only industry-endorsed research of its kind. The MoneyTree Report is the definitive source of information on emerging companies that receive financing and the venture capital firms that provide it.” *Id.*

stage of development, and industry group, from 1995 to the most recent quarterly results.²⁴¹ This information, coupled with the data collected as part of the reporting requirements defined in the Act, provides the baseline information necessary for policy makers to assess program impact and to make program improvements.²⁴²

Although each TNInvestco was selected in part based upon its investment strategy, it is unclear whether the current group of “Qualified TNInvestcos” will make statewide investments across all industry groups or only a small subset, as the Act does not limit TNInvestco investment to particular industry segments.²⁴³ As a practical matter, however, most venture capital funds tend to gravitate towards industry groups in which they possess expertise and serve those areas that are familiar.²⁴⁴ As a result, the investment capital made available through the TNInvestco program may remain concentrated and may serve only to replace that which is available from the private sector. It is imperative that the DECD monitor the TNInvestco fund investments and compare the results to the historical data of venture capital investments to ensure that the program is achieving its desired objectives.²⁴⁵ For the TNInvestco program to be successful as an economic development tool, it must complement the state’s comprehensive economic development strategy and encourage private investment in target industries and geographic areas.²⁴⁶

As part of the state’s efforts to establish a “world-class graduate energy

²⁴¹ *Id.*

²⁴² *See* TENN. CODE ANN. § 4-28-110; PRICEWATERHOUSECOOPERS, *supra* note 240.

²⁴³ TENN. CODE ANN. §§ 4-28-105(c)(1)(A)(iii), -108.

²⁴⁴ Grudkova & Benton, *supra* note 95, at 14.

²⁴⁵ For example, in 1988 the Money Tree dataset indicates that there was a total of \$74 million in venture capital invested in 23 Tennessee businesses. *See* PRICEWATERHOUSECOOPERS, *supra* note 240. Of this amount, \$4M was invested in four startup/seed businesses; \$30M was invested in seven early stage businesses, and \$18M was invested in six later stage businesses. *Id.* In terms of industry groups, the top three investments were: \$28M invested in healthcare/biotech, \$13M in media/entertainment, and \$9M in information technology software and services. *Id.* The most venture capital invested in Tennessee businesses was in 1999 (\$473 million). *Id.* The annual amount of venture capital invested has been declining from this high: 2000 (\$454 million), 2001 (\$205 million), 2002 (\$130 million), 2003 (\$82 million), 2004 (\$86 million), 2005 (\$104 million), 2006 (\$42 million), 2007 (\$124 million), 2008 (\$74 million), 2009 (\$30 million) through three quarters. *Id.*

²⁴⁶ *See* Grudkova & Benton, *supra* note 95, at 12.

sciences and engineering program” at the University of Tennessee and Oak Ridge National Laboratory, the Administration hopes that it will attract both federal funding and venture capital.²⁴⁷ Given the national focus on promoting the development of cleaner and less expensive forms of energy, Governor Bredesen hopes that this concentration of technological innovation expertise, which promises to contribute to the development of products and services that are in demand in the marketplace, will spawn technological innovation and economic growth on the scale experienced in Silicon Valley.²⁴⁸ If the TNInvestco program is to expand, the selection process should take into account such ancillary strategic economic development objectives and ensure that fund managers have both the appropriate industry experience and are located in a reasonable proximity to those businesses that are receiving investments in order to better add value through the mentoring process.²⁴⁹

Furthermore, the need for continuous TNInvestco program improvement cannot be overstated. Those states that have implemented venture capital programs similar to that of Tennessee’s have made numerous changes over time.²⁵⁰ However, these changes were generally a reactive response to program inefficiency and ineffectiveness.²⁵¹ The TNInvestco enabling legislation incorporates a number of unique improvements designed to avoid many of the problems encountered by these other programs.²⁵² Despite these improvements, new issues will likely arise. Ongoing program monitoring is essential to address such unanticipated issues and

²⁴⁷ Rodger Harris, *Program Expands UT’s Ties to ORNL*, KNOXVILLE NEWS SENTINEL, Jan. 9, 2010, available at <http://www.knoxnews.com/news/2010/jan/09/program-expands-uts-ties-to-ornl> (quoting Governor Phil Bredesen).

²⁴⁸ See *id.* This would further expand the technological expertise in energy and engineering that already exists at the University and Oak Ridge, along with that found regionally at the Tennessee Valley Authority and the Electric Power Research Institute. *Id.*

²⁴⁹ See *id.*; METRICK, *supra* note 13, at 9.

²⁵⁰ See Barkley, *supra* note 2, at 355-59. For example, Louisiana “was initially structured with a 200% tax credit for insurance companies . . . and a 35% income tax credit for other investors.” *Id.* at 355. However, there was little activity in the program until five years later, when the program introduced a bond-type instrument which provided insurance companies with a fully insured return of principal and a guaranteed rate of return. *Id.* The Louisiana legislation has been amended numerous times: the 200% tax credit was reduced to 120% in 1989 and to 110% in 1998. *Id.* at 356.

²⁵¹ See *id.* at 355-59.

²⁵² See TENN. CODE ANN. §§ 4-28-102 to -112 (Supp. 2009).

correct them proactively.²⁵³ If managed properly, appropriate program monitoring can be a source of support to the TNInvestco fund management, rather than a bureaucratic impediment.²⁵⁴

VI. CONCLUSION

The TNInvestco program is an economic development tool that enables the State of Tennessee to encourage private-sector investment activity in target industries and geographic areas.²⁵⁵ In light of the role venture capital plays in the formation of developing industries and businesses, the TNInvestco program may be used to effectively cultivate small businesses in high-growth industries.²⁵⁶ The TNInvestco program lends itself to modifications in response to industry trends, and it provides a framework for Tennessee to foster entrepreneurship.²⁵⁷ The true value of the TNInvestco model is its ability to achieve public economic development objectives through free market capitalism.²⁵⁸

²⁵³ See METRICK, *supra* note 13, at 9.

²⁵⁴ See *id.*

²⁵⁵ See TENN. CODE ANN. §§ 4-28-102 to -112.

²⁵⁶ See *id.*

²⁵⁷ See *id.*; Grudkova & Benton, *supra* note 95, at 11.

²⁵⁸ See TENN. CODE ANN. §§ 4-28-102 to -112; Grudkova & Benton, *supra* note 95, at 12.