

# Compensation Provisions in a Venture Capital-Limited Partner (VC-LP) Contract : A Theoretical Framework

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## Abstract

In a venture capital (VC) deal, a partnership contract is designed to avoid different conflicts arising due to information asymmetry and agency problem and to make appropriate provision for compensation. This study investigated different theoretical approaches that have been deployed to understand this phenomenon. This article extracted the important aspects of the compensation structure and covenants required to set in the contract between venture capitalists and their limited partner (LP) in order to meet the agreed-upon proportion of return distribution and proposed a VC compensation model. Various studies were analyzed to get evidence on various aspects of a VC deal, such as the reasons why professional VCs exist, and factors that determine the design of a contract. Private ownership, information asymmetry, and illiquidity associated with a VC investment are key explanatory factors, which make VC – LP partnership agreement different from other financial contracts. The findings of this study could be alienated into two constituents. First, the compensation that a VC receives from its LP is performance based, which varies according to the size of the fund, experience of VC, past performance of VC, and signalling function. Second, some important covenants are generally mentioned in such a contract during raising funds for investments, though these are heterogeneous in each deal and their contribution in compensation allocation varies with each deal. In this study, we have proposed a compensation model for venture capitalists as a general partner by their limited partner, which is based on a principal-agent model. Also, this study focuses on contractual covenants, which are responsible for imparting flexible incentive provision and provide control over VC activity. The arrangement of VC compensation and covenants depend upon the management support and effort of VCs. This study can contribute to resolving the conflicts - between venture capitalists and their investors - that arise due to the agency problem and bring to light the compensation arrangement and provision of covenants used in the contract between VCs and their LPs.

**Key words:** venture capitalist compensation, VC contract, principal- agent model, contractual covenants, limited partner

**JEL Classification :** G23, G24, G31

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As an institution, venture capital (VC) firms operate in a very dynamic business environment, which involves three parties in its investment process. In the organizational structure of the VC industry, the limited partners (LP) passively get involved in the fund management, but monitor and control the activities of a fund manager through a partnership agreement. There exists two forms of partnership in a venture capital deal, one is between a VC and an entrepreneur firm, and the other is between a VC and the investor, that is, the limited partner (LP). At present, the momentum of the venture capital industry basically depends upon these limited partners, who are the source of a pool of funds. A handful of theoretical and empirical literature

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**Table 1. Percentage of Number and Size of Fund Allocation to Venture Funds by Different Investors (LP)**

Types of LP	Co-investment		Foreign		Indian based		Unknown	
Year	Percentage of total Number of investment	Percentage of total amount of fund invested	Percentage of total Number of investment	Percentage of total amount of fund invested	Percentage of total Number of investment	Percentage of total amount of fund invested	Percentage of total Number of investment	Percentage of total amount of fund invested
1998	0.0	0.0	41.18	90.22	58.8	9.78	0.0	0.0
1999	6.5	1.7	43.48	80.77	50.0	17.50	0.0	0.0
2000	5.2	7.8	19.13	65.79	75.7	26.45	0.0	0.0
2001	7.5	5.0	28.75	78.77	63.8	16.25	0.0	0.0
2002	8.2	6.2	39.34	78.13	52.5	15.69	0.0	0.0
2003	12.7	6.4	26.98	66.00	60.3	27.63	0.0	0.0
2004	6.9	8.4	46.53	73.40	46.5	18.15	0.0	0.0
2005	10.8	19.0	37.11	57.71	52.1	23.29	0.0	0.0
2006	7.2	27.5	41.18	47.60	51.2	24.88	0.5	0.0
2007	8.3	20.9	42.45	58.07	49.1	20.74	0.2	0.3
2008	12.0	17.5	36.46	49.12	51.5	33.37	0.0	0.0
2009	10.5	16.8	31.47	44.98	58.0	38.24	0.0	0.0
2010	10.3	16.4	33.25	53.72	56.0	29.74	0.5	0.1
2011	12.1	14.8	33.33	55.67	54.6	29.51	0.0	0.0
2012	12.6	11.6	31.10	63.48	56.3	24.87	0.0	0.0
2013	14.2	13.5	32.02	63.69	53.8	22.83	0.0	0.0

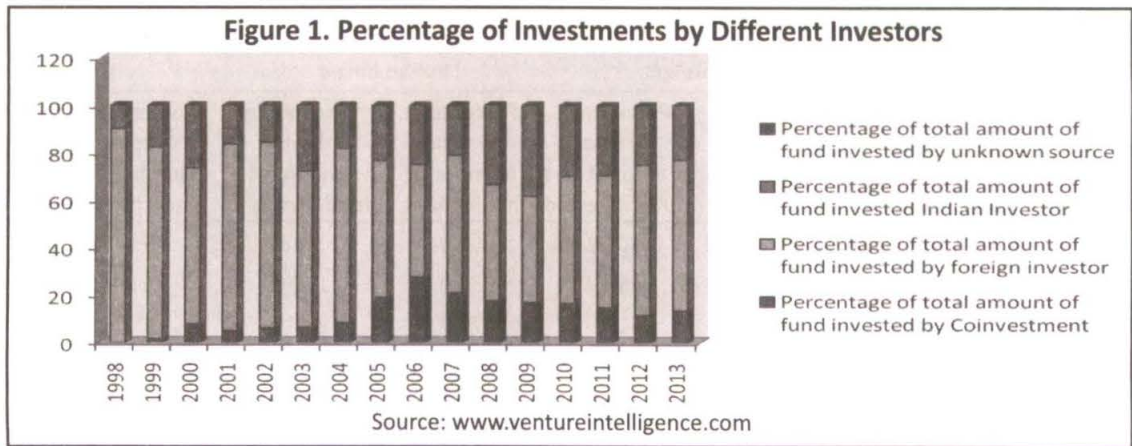
Source: [www.ventureintelligence.com](http://www.ventureintelligence.com)

concentrated upon exploring the relationship between VCs and their LPs (Da Rin, Hellmann, & Puri, 2011). The most crucial part of the relationship is the compensation structure between them in a deal. This phenomenon is not unambiguous due to lack of attention and lack of availability of properly required information.

Due to the presence of more than one party for a financial transaction in a VC deal, two contracts exist in a deal to minimize the uncertainties due to the agency problem and information asymmetry problem between VC and LP or VC and the entrepreneur firm. Generally, to invest in an entrepreneur firm, VCs can raise funds from multiple investors depending upon the fund size and can sign a contract with each of their investors. In India, the type of investors is diversified consisting of both Indian and foreign investors. The Table 1 depicts the percentage of number and size of fund allocation to venture funds by different LPs or investors in each year from 1998 to 2013. Again, as per the Figure 1, it is clear that the major proportion of investment amount in the Indian VC industry comes from foreign investors. Higher variance in returns (Braun & Schmidt, 2014 ; Caselli, Garcia-Appendini, & Ippolito, 2013 ; Robinson & Sensoy, 2013) and high risk might be a major cause of low involvement of Indian investors in this industry.

As a financial intermediate, VCs raise their funds from LPs and invest in potential avenues. In such a limited partnership structure, there could arise serious conflicts if any deviation is found in the interest of both parties. For this, they go through a partnership agreement between them to avoid any conflict.

It is evident from the findings of the past studies that the partnership agreement between a VC and LP differs from fund to fund in terms of contractual terms and conditions. These contracts contain the compensation structure of VCs and provision of covenants. By studying the above facets of a VC deal, this study tries to enlighten the prevailing model of limited partnership and how VCs get compensated from LPs. In order to



minimize different potential problems like adverse selection and moral hazard problems between venture capitalists and their limited partners, the contract specifically contains the detailed structure for compensation to VC and inclusion of covenants. Through this, the LPs can better monitor and control the activities and efforts of their VC professionals. This study will contribute in creating value in the venture capital industry by addressing the principal-agent problem that exists in venture capital investments ; explicitly in the compensation structure of investors (LPs) and fund managers (Vcs). Also, this study tries to provide key explanatory variables for presence of covenants in the contract.

## Theoretical Background

According to Gompers and Lerner (2000), venture capitalists are in obligation to their limited partners through the partnership agreement, which is designed to control the agency problem and information asymmetry problem (Ross, 1973). Venture capitalists are liable to pay out their investors in a specific time frame, failure of which could lead to severe consequences as per mentioned in the contract. Therefore, LPs choose their general partners (GP, here, VC), who have a good track record and past performance.

Zeckhauser and Pratt (1985) asserted that there are two kinds of informational problems that exist in a typical principal-agent framework. One is asymmetry of information or hidden information, and another is moral hazard or hidden action. A limited partnership investment structure is a vehicle of VC investment to mitigate these aforesaid problems (Mehta, 2004).

According to Chung, Sensoy, Stern, and Weisbach (2012), VCs who manage the funds always try to maximize the income generated from the funds by balancing their track record and short term interests. Every time, this might not fit in alignment with expectations of a limited partner. Such circumstances could lead to conflict between the interests of both parties.

Gilson and Schizer (2003) explained that a good track record of a VC is based on their past performance in terms of a number of successful deals and years of experience, which builds their reputation. VCs' performance and their reputation have major implications on raising funds from their investors or Lps.

According to Covitz and Liang (2002), to sustain a good track record and their reputation, GPs emphasize on their compensation structure. This structure has two components : one is fixed, and another is variable. This variable portion of compensation motivates VCs to exert more effort. On the other hand, LPs try limiting the activities of VCs according to their interest and putting some covenant in the contract. Gompers and Lerner (1996) supported the use of long-term contract to govern the relationship between two parties in a financial contract as short term contracts are generally too costly and difficult to implement.

Sahlman (1990) mentioned that VCs receive a contract from an investor where it is mentioned that they will be given some benefit with the mentioned cash flow right, and both design their compensation arrangement from the success of their investor. Gompers and Lerner (1996) found that in a VC-LP contract, they generally used some covenants in terms of legal restrictions in order to minimize the potential uncertainties in the deal outcome. In another way, VCs enjoy some private benefits from the use of these covenants.

Gompers and Lerner (2001) developed a set of hypothesised relationship between different aspects of venture capitalists. They found that older and larger VC firms had been earning a larger share of their income in the form of incentives rather than as a flat percentage of net asset value as stated fee. In the partnership contract of VC-LPs, the distribution of stated fee and incentive pattern is not yet clear.

## **Structure of a VC Deal**

There exist two-fold relationships in a typical VC deal, one is between VC-LP and another is between VC and its entrepreneur firm. The presence of multiple principal-agent relations in a VC model is due to which there is high possibility of the existence of the agency problem. The agency problem arises owing to a conflict of interest of both parties. This results into increasing the agency cost. To make a deal successful and to add value, this problem must be minimized and benefit minus cost should be maximized.

According to Sahlman (1988), to resolve this problem, there should be a contract between two parties. In a VC model, there exists two contracts between three parties. One is between VCs and their LPs (Litvak, 2009) and another is between VCs and their entrepreneur firms (Sahlman, 1990). These two contracts are different in their structure, but have an impact on each other. This study is based upon how to bring clarity on this contract design in the VC market to make the deal successful. These VC contracts include controlling rights and uses some restrictive covenants to minimize the agency problem and make information availability clearer. VCs get compensation according to the provision made in these contracts.

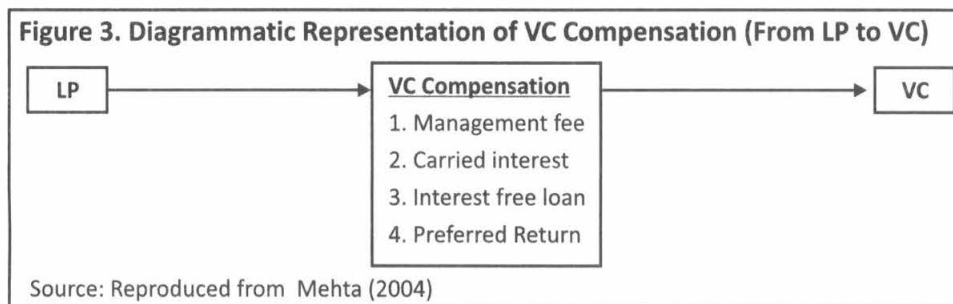
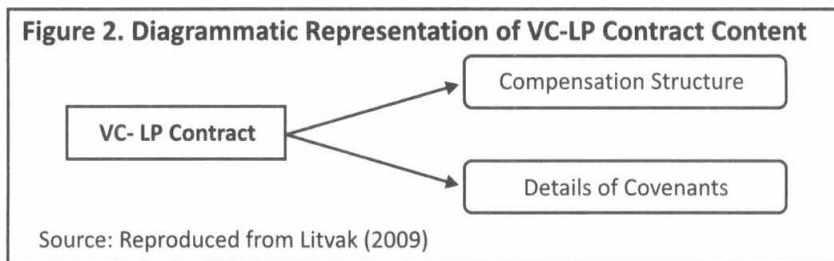
## **Requirement of a Contract**

Two arguments explain why there is a need for the existence of a financial contract in a deal between two parties. First, Modigliani and Miller's (1958) financial theory in the real world is a failure, as it describes that investments are made due to a gain of profit in the financial market where there is no transaction cost, no taxes applicable. But in the real world, there exists transaction costs and provision of taxes. To meet this problem, a financial contract is required (Admati & Pfleiderer, 1994).

Second, according to Hart (2001) ; Axelson, Strömberg, and Weisbach (2009) ; Chung et al. (2012) ; and Mulcahy, Weeks, and Bradley (2012), when there is the existence of two or more parties, the conflict could arise due to the difference in their interests, which is called as an agency problem. To resolve this problem, the financial contract is needed which consists of the provision of contingencies made to principal for their financial and non-financial (Krishnan, Ramasamy, & Joshi, 2014) activities. The principal - agent model describes this provision of compensation to an agent in some specific situations.

In the case of a VC-LP agreement, a LP provides funds to a VC and maintains the limited partnership throughout the fund's life where there is no control over fund utilization. The ownership on the fund shifts to the VC. Therefore, to control the activities of a VC, a LP goes with predetermined terms and conditions written in a document known as 'partnership agreement' or 'contract'.

✦ **Stylized Facts on VC Contract (LP to VC) :** In a LP-VC contract, a VC gets funds from a LP and puts this fund in different portfolio firms with their managerial skill and knowledge. Broadly, this contract holds the compensation



framework and provision covenants as depicted in the Figure 2. According to the study of Litvak (2009), in the contract between VCs and their LPs, the following provisions are generally mentioned. VCs get their payoff from their LPs through this contract in the following mode :

**VC Compensation: Management fee (2-3% of total invested amount) + Carried interest (20-25% of profit earned) + Interest free loan (value of distribution) + preferred return by VC (Mehta, 2004).**

In the Figure 3, this break up of compensation is shown diagrammatically.

The VCs' compensation from their LPs consists of the management fee carried interest and hidden benefit by getting interest-free loan. Their compensation consists of both fixed and variable component. Management fees is the fixed component ; whereas, carried interest is the variable one. Various empirical studies have shown that older and larger funds are associated with higher level of management fees as compared to younger and smaller funds (Gompers & Lerner, 1999). Litvak (2009) explained that there exist large complexities in the compensation pattern of VCs; this may be due to the hiding of true compensation structure for them. The above structure is found to be straight forward, but the calculation of management fees undergoes higher complexity. It is yet to be found if the net present value increases, whether the structure of management fee will increase or not, and if it increases, then up to which extent ? From his study, Litvak (2009) found that as these management fee calculations differ from deal to deal and time to time based upon the addition of extra funds during the fund life ; again, some other factor affects the design of this structure. The VC qualities, that is, their performance, years of experience, success rate determines the management support to increase the net present value of their invested funds.

The concept of carried interest can well be described through two models in previous literature. One is the learning model, which describes that a carried interest would increase over time as the fund size and reputation of the fund increases. Unlike the learning model, the signalling model says that carried interest decreases over time, and it is positively related to the performance of VCs. The findings of many empirical studies in previous literature support the learning model to explain that high variance in pay for performance is found in more experienced VC funds. They use their experience and skill, and are motivated to exert efficient efforts to get high variable pay. The carried interest could be increased through increasing fund size. This is determined through the VC quality, therefore, though it is not complex for a particular deal, but it varies from deal to deal. So, a successful VC receives a higher amount of carried interest.

As carried interest is based upon the profit realized from the investment, this could achieve the expected preferred return of VC. This expected preferred return is the function of cost to the VC. Covitz and Liang (2002) found that the provision of preferred return is more commonly found in younger VCs. This enhances the realization of higher returns, signalling of exerting efficient effort by VCs. Also, this can address the costly contracting theory. Covenants are included in the contract to avoid repeated costly negotiations.

## Compensation and Covenant Model of VC-LP Partnership Agreement

The VC-LP contract consists of the compensation pattern for the VCs in the form of management fee and carried interest. Again, the pattern of management fee structure is also mentioned. The management fee structure varies from deal to deal, and the calculation of management fee is based upon the preference of the LP. With this compensation design, the contract also contains some covenants or restrictions - these are generally used to control VCs behaviour (Gompers & Lerner, 1999). On the whole, the contract contains all terms and conditions followed by VCs and how they get paid off by their LPs.

Here, we have considered these two features of the VC-LP contract, and try to develop a theoretical model which could influence the constructing of an efficient contract between VCs-LPs as both the compensation structure and covenant used are dependent upon each other.

**(1) Model of Compensation Structure (Based on Principal-Agent Model) :** According to Kaplan and Strömberg (2003), in a venture capital deal, a contract is designed to mitigate the risk arising due to the agency problem between the parties in such a deal. Most financial contracts generally address how the conflict between a principal (an investor) and an agent (venture capitalist) could be resolved. The principal-agent problem leads to an unpredictable future outcome, which is generally controlled through structuring a contract between two parties. To minimize this problem, these contracts contain the compensation structure which varies with the effort supplied by VCs. Most of the empirical studies on performance based- compensation structure have been conducted on VC-entrepreneurial firm contract. However, this aspect in case of VC-LP contract requires more extensive studies both in theoretical and empirical perspectives.

It is well understood that the existence of the principal-agent relationship affects the compensation structure in a typical VC-LP contract. However, it is evident from the past studies that the provisions made on the contract regarding compensation structure are heterogeneous with respect to a different deal.

The compensation of VC contains both fixed and variable parts. The fixed part comes from the management fee set in the contract ; whereas, the carried interest and proffered return are the base of variable compensation. Gompers and Lerner (1999) explained that this variable compensation is the function of effort, performance of VCs, and size of fund raised by them.

$$C = C_F + C_V$$

where,  $C$  is the compensation to VC,  $C_F, C_V$  are the fixed and variable compensations, respectively.

Fixed component of compensation is based upon management fee ( $mngft$ ), experience ( $exp$ ), age ( $age$ ), performance ( $perf$ ), and investment stage ( $stage$ ) of VC ; whereas, it is ambiguous about the variable pay structure of VC.

$$C_f = f(exp, mngtf, age, perf, stage)$$

VCS always try to maximize their compensation after returning the committed capital to LPs. This variable

portion of compensation is dependent upon effort supplied by VCs, situational outcome, generation of efficient results due to their signalling function, investment decisions made by them, and so forth. This compensation consists of both financial and non financial activities.

In this study, the design of the compensation structure is based upon the interest of both VCs and LPs, where the VCs try to maximize the monetary value of their exerted efforts with some fixed provision of compensation and principal and try to maximize their returns on investment after allocating agent's compensation.

Here, a compensation model has been anticipated based upon the principal - agent theory for the VC compensation structure in a VC-LP contract.

In a VC-LP deal, a VC tries to maximize its variable compensation ' $C_v$ ' by putting effort ' $e$ ' and ' $X$ ' is the output and  $M(X)$  is the monetary value of outcome, and then the objective of the VC becomes:

$$\text{Maximize } C_v = [M(X(e)) + B(e) - c(e) - R(e) + \alpha^T \mu(e)] \quad (1)$$

Subject to  $\alpha^T \mu(e) > c(e)$

where,  $B(e)$  is the private benefit received by VC,  $c(e)$  is the cost borne by VC for effort supplied,  $R(e)$  is the residual loss incurred by VC due to wrong investment decisions, and  $\alpha^T \mu(e)$  is the efficient output ( $\alpha$ ) generated by a VC over continuous time  $T$  due to its signalling function  $\mu$ .

So, the total agent's output becomes a function of effort ' $e$ ' supplied by an agent.

$$X = f(e, \varepsilon)$$

where, ' $\varepsilon$ ' is the random variable which is outside the VC's control.

However, the utility function is linear for income as there is no income effect on effort supply ; so, the monetary value of their compensation is influenced by the utility function as follows :

$$C_v = U[M(X(e)) + B(e) - c(e) - R(e) + \alpha^T \mu(e)]$$

where  $dU/de > 0$ ,  
and  $d^2U/de^2 < 0$ .

In the context of LPs, they prefer to give monetary compensation with respect to output ' $X$ ' and yearn to maximize their returns on investment ' $RI$ ' over cost of investment ' $cl$ '. As risk adverse investors, they expect the risk premium  $1/2r\alpha^T \Sigma \alpha$  from their investment on VC funds after giving compensation based on their efforts (Holstrom & Milogram, 1991).

So, the objective function of LP becomes :

$$\text{Maximize } RI - M(x(e)) - cl + 1/2r\alpha^T \Sigma \alpha \quad (2)$$

Subject to :

- (i) Agents try for the positive increment of their monetary value of compensation with respect to change of their effort supplied.
- (ii) According to an agent's participation, the agent's compensation becomes higher.
- (iii) The agents continuously choose to change their efforts over a time interval  $[0, 1]$ .

This is called participation constraint. It ensures that solution is “Pareto optima,” that is, one party is getting better off without negatively affecting the other. So, here, the LP first tries to choose the action of VC 'e' for deciding the value of  $M(X)$ .

By varying the target compensation value, the best results could be attained according to the effort supplied by the agent. It is evident from real practices that the contract is generally incomplete. This actually happens due to the presence of non-verifiable parameters affecting the cost incurred by investor and compensation paid by them. According to Fama and Jensen (1983) and Fama (1980), if a principal has a variety of information about the agent, then the agent behaves according to the interest of the principal. This could lead to minimization of is utilized effort made by the agent.

The solution of objective function of LP itself contains the solution for VC compensation which is based upon the effort of VC exerted for the efficient outcome. The determination of monetary value of effort 'e' could bring clarity on the compensation framework of VC, especially on a variable component. The efficiency level of VCs' operation would increase according to their experience, success, and performance, which affects their signalling function. This efficiency gives them more probability of high returns. With this, there is a chance of increasing the risk appetite of VCs, which is not always acceptable by their LPs. To control this, LPs put some provision of covenants in the contract with compensation structure.

This study considers the contribution of signalling function of VCs for increasing their output over time  $T$ , which affects the subsequent inflow of funding from LPs. Here, the determination of degree of covenant present in the contract is crucial to analyze the compensation framework of Vcs.

**(2) Theoretical Model for Determination of Degree of Covenant :** A venture capital contract contains the compensation structure of VCs by their LPs ; with this, it also contains some covenants. According to Gompers and Lerner (1996), the pension fund and institutional investors generally invest in venture funds as limited partners. Here, they do not involve directly in the utilization of the funds. So, to validate and control the behaviour of the general partner, the roles of these covenants are indispensable. To mitigate the information asymmetry problem between the LPs and VCs, the covenants are included in the contract. It is evident that the contract features determine how to govern a healthy relationship between LPs and GPs in over the life of their deal.

A VC-LP contract is generally quite different from another partnership contract as it is rarely renegotiated. It indicates the covenants present in the contract from the beginning will stay on as long as everything goes well. Again, Gompers and Lerner (1996) argued that the determination of the presence of covenants is governed by several factors, especially the demand and supply of the venture fund at the current market situation. The shift in demand of fund leads to addition and deletion of a number of covenants in the contract. With this, the cost incurred for the design of contract and putting a covenant there plays a major role in the inclusion of covenants in the same. From their sample study of VC-LP contracts in different deals, they found that there existed three major category of covenants used in a VC-LP contract. Gompers and Lerner (1996) mentioned that there are three categories of covenants commonly used in a VC-LP contract as shown in the Table 2, which again explicit into numbers of sub covenants under each category.

In a long term contract, the demand of a VC fund, at a particular state of time, affects the use of covenants in a contract (Gompers & Lerner, 1999). Their study asserted that funds having higher demand, with high experience are better performers and they have lesser number of covenants in their contract set by LP s. It is evident from prior studies that the size of fund required by VCs, their opportunistic behaviour, like funding high technology start-up and past success also leads to inclusion of a low or a high number of covenants in the contract. It is evident that VC funds focused upon investment in early stage portfolio have higher number of covenants in their contract.

Again, putting a specific covenant in the contract could be a major discussion for future research which may require simulating different outcomes of the deal and covenants used in the VC-LP contract. In this context, the following model can be proposed for determining the degree of covenant used whether it is higher, moderate, or



**Table 2. Categories of Contractual Covenants in a VC-LP Deal**

Categories of Contractual Covenant	List of Covenants Under Each Category
Covenants relating to the management of the fund:	Restrictions on size of investment in any one firm. Restrictions on use of debt by partnership. Restrictions on co-investment by organization's earlier or later funds. Restrictions on reinvestment of partnership's capital gains.
Covenants relating to the activities of the general partners:	Restrictions on co-investment by general partners. Restrictions on sale of partnership interests by general partners. Restrictions on fund-raising by general partners. Restrictions on other actions by general partners. Restrictions on addition of general partners.
Covenants relating to the types of investment:	Restrictions on investments in other venture funds. Restrictions on investments in public securities. Restrictions on investments in leveraged buyouts. Restrictions on investments in foreign securities. Restrictions on investments in other asset classes.

Source: Reproduced from Gompers and Lerner (1996)

lower in a VC-LP contract. This could be determined through various determining factors.

$$VCLP_{Cov} = \alpha + \beta_1 VC_{demandi} + \beta_2 VC_{fundsizei} + \beta_3 VC_{expi} + \beta_4 VC_{pastsuccessi} + \beta_5 VC_{vintage\ year} + \beta_6 VC_{investmentstage} + \beta_7 VC_{opp.behvi} + \epsilon_i$$

$VCLP_{Cov}$  = Degree of presence of contractual covenants in a VC-LP contract (whether high, moderate, or low),

$VC_{demandi}$  = Demand of VC fund at a particular state of time  $i$ ,

$VC_{fundsizei}$  = Size of fund required by VC from LP at a particular state of time  $i$ ,

$VC_{expi}$  = Experience of VC fund in years at a particular state of time  $i$ ,

$VC_{pastsuccessi}$  = Number of successful exit of VC funds earlier at a particular state of time  $i$ ,

$VC_{vintageyear}$  = Year of first investment is raised from LP,

$VC_{investmentstage}$  = Investment stage focused by VC fund at the particular time  $i$ ,

$VC_{opp.behvi}$  = Degree of VC's opportunistic behaviour at a particular state of time  $i$ ,

$\epsilon_i$  = Random error.

The determination of the degree of covenant used in the contract could lead to restricting the activities of VCs and minimize the agency problem and information asymmetry problem. Through this, the costly contracting can be reduced. This model supports the findings made in the study of Gompers and Lerner (1996) and Mehta (2004); whereas, it slightly differs by emphasizing the role of vintage year on the determination of covenant. The time gap between initial and subsequent investment by LPs on VC funds depends on the expected return of initial funds, deviation of which affects the inclusion and exclusion of different covenants.

## Practical Implications

Many aspects about the VC-LP contract are still ignored. Understanding the compensation structure between them is vital for raising and allocating VC funds for potential investments. There are very few conceptual and empirical research studies that have been conducted in this area of contract design between VCs-LPs due to unavailability of sufficient information. Specifically, in the Indian context, studies of such kind are rarely found. Such a study could be useful in exploring the potential financial resources that new entrepreneurial firms could avail through VC funding.

Again, the agency problem existing between the two parties could be resolved up to the maximum extent. In this study, the principal-agent theory is incorporated for designing a compensation structure. This may lead to compensate the desired effort supplied by the agent according to the interest of the principal and suggests how the covenants would be used in the contract to put restrictions on the activities and behaviour of VCs. The inputs of the model clarify that professionalism of VCs in terms of their experience and performance influences their compensation structure. It is evident that the compensation structure and covenant used are complementary to each other. The quantification of sign and magnitude of different observable parameters in a contract would be helpful for the understanding of the contract structure. This could contribute to mitigate imminent problems like agency problem, moral hazard problem, and attract more potential investors to invest in the VC industry. The structure and design of the contract is responsible for the success and failure of the contracting mechanism with proper alignment of VCs and LPs through a proper compensation framework. This can enhance the expectation of LPs for higher rates of returns and catch the attention of the VC industry.

## Conclusion

Use of covenants and designing the compensation structure are real reasons for constructing a VC-LP contract. Many studies found that the use of covenants affect the activities made by the VCs and minimize the agency problem in this relationship. The effort supplied by the agent influences the design of the compensation structure for VCs according to the interest of principal or limited partner of the deal.

From the previous studies, hypotheses made by several authors about the conflict due to compensation arrangement could be proved by considering the principal-agent model, which could explain how both parties got their better pay off without affecting the other's payoff. Past studies already mentioned that VCs get their compensation from the management. Fee and carried interest are a flat percentage of fund size and profit earned. However, studies found that this structure is quite complex and varies from deal to deal. With this, VCs also get some other benefits which are based upon their performance. So, design of management fee structure is also affected by VCs' performance (Litvak, 2009). A simultaneous study on compensation and covenant structure could bring more input for a successful contract mechanism. This study could lead to constructing an efficient compensation model by simplifying the existence of a complex structure through minimizing the agency problem. Future studies can empirically test the validity and increase the efficiency of the model through proper interpretation of various information regarding VC and LP partnership agreements.

## Limitations of the Study and Scope for Further Research

Due to the private nature of the VC industry, accumulation of data regarding limited partnership contract, information regarding various contract provisions, and return from funds is very difficult. A major source of knowledge are the studies conducted in this area. The limited information available about this industry is a major limitation for research in this industry. Due to this non availability of information, it was not possible to

empirically test the regression model presented in the paper. Due to these issues, quantifying different observable components of a compensation model was not possible. Determination of various exogenous error terms also needs to be explored.

Every limitation can be a hope for a new beginning. This study is based on model of compensation and covenant used in the VC-LP agreement. Empirical validation of these models in case of availability of information is a new scope for further research. Again, other aspects of this partnership agreement are still unturned and yet to be studied. Different other parameters could be studied for better understanding of the compensation pattern of VCs through keen observation of different individual deals, which is quite difficult in the Indian context. Again, individual analysis of each covenant used and its implication in the efficiency of the deal flow can be a possible novel research in the field of VC industry. This would result in future research on developing performance-based compensation models that will be flexible enough for considering different practical situations.

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