

# NONTRADITIONAL VENTURE CAPITAL: AN ECONOMIC DEVELOPMENT STRATEGY FOR ALASKA

*This Note begins by analyzing Alaska's current economic position and the reasons behind the state's lack of traditional venture capital sources. The author describes both traditional and nontraditional mechanisms of venture capital, finally concluding that Alaska should adopt a nontraditional form of venture capital in order to spur economic growth in rural communities and in slow-growth industries. Such a fund can have a dual benefit of providing a financial rate of return while promoting economic development.*

## I. INTRODUCTION

Exclusive reliance on traditional methods of economic development in Alaska has hindered the state's economic growth and has poorly positioned the state to meet the challenges of twenty-first century market forces. While the traditional economic strategies focus on waiting for the next big oil discovery or for the relocation of a large company to Alaska, in a newer, more competitive marketplace, it may be more productive for state and local governments to focus on ways to increase opportunities for small business entrepreneurs. Small businesses add jobs, strengthen the tax base, and improve overall quality of life for many members of the surrounding community.

Current economic development indicators in Alaska suggest that many small business entrepreneurs lack access to financing sources that could help new businesses start or expand existing operations. In particular, these entrepreneurs need risk capital,<sup>1</sup> such

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1. Risk capital includes research and development capital, innovation capital,

as venture capital, to help their businesses get off the ground, move to a new stage of development, or facilitate restructuring efforts.

This Note will analyze the need for new economic growth in Alaska, both in terms of how Alaska is providing for the economic needs of its citizens internally and how Alaska's economy compares to the economies of other states. Next, the Note will consider the current need for equity financing in Alaska and whether traditional forms of venture capital have sufficiently met this need. Finally, the Note will propose that a nontraditional venture capital fund could better fill the equity gap in Alaska and will suggest recommendations for how to create such a fund that would stimulate economic development across the state.

## II. THE NEED FOR NEW ECONOMIC GROWTH IN ALASKA

Alaska's economy has traditionally been built on the state's vast natural resources, with the bulk of the state's income coming from oil drilling revenues, federal money, or new service sector jobs created by tourism.<sup>2</sup> These industries, particularly the oil industry, have given Alaska great economic success over the years. In fact, much of Alaska's economic history is considered in terms of pre-Prudhoe Bay and post-Prudhoe Bay.<sup>3</sup>

A significant portion of the state's oil revenue has been invested in the Alaska Permanent Fund.<sup>4</sup> The Permanent Fund was created in 1977 after the state began exporting oil from the North Slope, in order to set aside oil revenues for Alaskans and to prevent politicians from spending all of the money at one time.<sup>5</sup> While

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seed capital, venture capital, and mezzanine capital. *See* discussion *infra* Part III.A.

2. LINDA LEASK ET AL., INST. OF SOC. AND ECON. RESEARCH, TRENDS IN ALASKA'S PEOPLE AND ECONOMY 2 (Oct. 2001), *available at* <http://www.aknf.org> ("Alaska's economy. . . still depends heavily on state government spending and on a few resource industries."). Service and trade industries created half the new jobs since 1960, as Alaska's economy matured and established local support industries and as tourism increased. Injection of about \$1 billion annually into the economy from Permanent Fund dividends continued to fuel growth in these industries in the 1990s. *Id.* at 6.

3. The Prudhoe Bay oil field, the largest discovered in North America, was found on land owned by Alaska in 1968. By 2001, Alaska had collected over \$55 billion in revenues from oil production. *Id.* at 2.

4. *Id.*

5. SCOTT GOLDSMITH, CONFERENCE ON ALBERTA: GOVERNMENT POLICIES IN A SURPLUS ECONOMY, REFLECTIONS ON THE SURPLUS ECONOMY AND THE ALASKA PERMANENT FUND 1 (2001). The creation of this fund was a reaction to the state's initial management of its oil windfall when over \$900 million, which had

the Permanent Fund has been successful in turning Alaska's depleting oil resource into a renewable financial resource,<sup>6</sup> it cannot be viewed as the solution for all of the state's economic problems. Indeed, there is currently a lack of consensus regarding how the Permanent Fund should be used to offset current state budget shortfalls.<sup>7</sup>

Even with the Permanent Fund as an economic safety net, it is questionable whether Alaska can continue to rely on its traditional economy for its economic health. Current economic indicators suggest that Alaska's economy is not well positioned to significantly improve in the near future. While national economy grew sixty percent in the past fifteen years, the Alaska economy hardly grew at all.<sup>8</sup> In fact, from 1986 to 2002, the Alaska economy grew by only one percent, and during 2002, it actually contracted by 2.9 percent.<sup>9</sup>

Much of Alaska's lackluster growth is based on the decrease in oil production since the mid-eighties.<sup>10</sup> Currently, oil production is only half of what it was in 1988.<sup>11</sup> Also contributing to the slow growth is the fact that those who work in high-wage industries are not seeing the same lucrative paychecks as in years past, and the growth in lower wage trade and service jobs has not taken up the slack.<sup>12</sup> This has "contributed to the slow growth in gross state product as well as in household income."<sup>13</sup>

Further, there is a disconnect between those industries that pay high wages and those that employ a large number of people. For example, even though oil brings income to the state, the industry itself does not require a large number of workers to conduct its operations.<sup>14</sup> In contrast, the service and trade industries, including

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been paid to the state for the original drilling leases, was squandered by the state government. *Id.*

6. *Id.* at 3.

7. *Id.* at 4.

8. SCOTT GOLDSMITH, INST. OF SOC. AND ECON. RESEARCH, HOW ARE WE DOING?—THE POST-PRUDHOE BLUES (2002), available at <http://www.iser.uaa.alaska.edu/Publications/HowAreWeDoing.doc>.

9. *Id.*

10. *Id.*; see also SCOTT GOLDSMITH, NINTH CONGRESS OF BASIC INCOME EUROPEAN NETWORK, THE ALASKA PERMANENT FUND DIVIDEND: AN EXPERIMENT IN WEALTH DISTRIBUTION 14 (2002) ("Alaska has relied almost exclusively on oil revenues to fund state government for a generation, but they have been declining for a decade.").

11. Goldsmith, *supra* note 8.

12. *Id.*

13. *Id.*

14. LEASK ET AL., *supra* note 2, at 6.

tourism, hire a larger number of workers, but do not pay their workers as much as those employed in other industries.<sup>15</sup> Concerns about the sustainability of the job base are aggravated by the fact that “[j]ob growth slowed in the 1990s, as oil production and state oil revenues dropped and several basic industries—those that bring new money into the economy—lost jobs.”<sup>16</sup> Rural Alaska is particularly concerned about maintaining job growth if the oil-based economy continues to decline, because, outside the larger communities, “[j]obs in the cash economy are scarce, despite the new jobs added in the 1990s, and the prospects for future growth are limited.”<sup>17</sup> This is especially true for Alaska Natives who comprise the majority of rural inhabitants and historically have been underrepresented in the labor force.<sup>18</sup>

The apparent “brain drain” of the state’s brightest young citizens adds further concern about Alaska’s economic future.<sup>19</sup> In Alaska, more students leave the state for college than in any other state, and this trend has only increased; from 1992 to 1998, the number of students seeking education outside the state increased from forty-eight to sixty percent.<sup>20</sup> This is a concern because students who attend school out of state are also far less likely to return to Alaska after graduation than students who remain in state.<sup>21</sup> In fact, during the 1990s, Alaska’s young adult population<sup>22</sup> declined by twenty-one percent.<sup>23</sup> That, in turn, has created higher costs for

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15. *Id.* at 7.

16. *Id.* at 6.

17. *Id.*

18. *Id.*

19. Ekaterina Bezrodnaya, *Brain Drain in Alaska*, at <http://www.alaskainvest.net.org/interns-article1.html> (last visited on Sept. 6, 2003).

20. LEASK ET AL., *supra* note 2, at 12.

21. Lee Gorusch, *UA Reverses Alaska’s Brain Drain*, ANCHORAGE DAILY NEWS, April 18, 2002, at B6, available at <http://www.alaska.edu/state/archives/2002press/UAAprogressGorsuchadn041802.html>.

22. This figure includes individuals between the ages of twenty-five and thirty-five.

23. Christine Schmid, *From Edibles to Equity Local Restaurateur Changed Careers, Not Priorities*, THE JUNEAU EMPIRE (Sept. 13, 2002), at [http://www.juneauempire.com/stories/091302/loc\\_marshall.shtml](http://www.juneauempire.com/stories/091302/loc_marshall.shtml); see also Karen McCarthy, *Alaska’s Brain Drain*, THE JUNEAU EMPIRE (June 14, 2002), at <http://www.juneauempire.com/stories/061402/let-letter1.shtml> (“In 1999, 31 percent [of University of Alaska students] left Alaska within one year of graduation, and 35 percent left within five years.”).

Alaskan companies who must then spend enormous amounts of money recruiting and relocating people from outside the state.<sup>24</sup>

Alaska's size and population density has also significantly affected Alaska's economic growth. Alaska is the largest state in the country, larger than Texas, Montana and California combined.<sup>25</sup> Yet, while the average population density in the United States is seventy-four persons per square mile, Alaska's population is one person per square mile, the lowest in the country.<sup>26</sup> Within the state, nearly three-fourths of Alaska's 627,000 citizens live in or around the three main cities, with the remainder of the state's population scattered throughout the rest of the state.<sup>27</sup> Low population density can hinder economic growth for several reasons. First, regions with low population density often lack the basic infrastructure to support industry development.<sup>28</sup> Second, residents of these rural areas are more likely to be dependent on a single employment sector; problems in that sector can have a devastating effect on the entire community. Finally, rural jobs tend to be low-wage or seasonal, which leads to a limited tax base to provide social services.<sup>29</sup> In a state as large as Alaska, there is also the additional reality that bringing a new business or industry into one part of the state is unlikely to have an effect on residents of other areas.

Alaska's economy is weak as compared to the other forty-nine states. The *2002 State New Economy Index* analyzed the potential for sustainable economic growth in the "New Economy" by considering how well each state fares in certain economic categories, in order to determine how well each state will handle the new realities of our changing economy.<sup>30</sup> The nature of this New Economy is

24. Gorusch, *supra* note 21.

25. ALASKA DEPARTMENT OF TRANSPORTATION AND PUBLIC FACILITIES, ALASKA TRANSPORTATION FAST FACTS, *available at* [http://www.dot.state.ak.us/stwdplng/planresc/fast\\_facts.html](http://www.dot.state.ak.us/stwdplng/planresc/fast_facts.html) (last visited Sept. 6, 2003).

26. *Id.*

27. LEASK ET AL., *supra* note 2, at 4. Note, however, that only thirty-two percent of Alaska Natives live within the six largest census areas. *Id.*

28. RURAL ASSISTANCE CENTER: ECONOMIC DEVELOPMENT, *at* [http://www.raconline.org/info\\_guides/communities/econ\\_dev.php](http://www.raconline.org/info_guides/communities/econ_dev.php) (last visited Sept. 28, 2003).

29. *Id.*

30. ROBERT D. ATKINSON, PROGRESSIVE POLICY INSTITUTE, 2002 STATE NEW ECONOMY INDEX (2002), *available at* <http://www.neweconomyindex.org/states/2002>. The "New Economy" refers to the changes in the national and global economies that occurred during the end of the 1990s and the beginning of the 2000s. It is characterized by a "complex array of forces" that include "the reorganization of firms, more efficient and dynamic capital markets, more economic 'churning' and entrepreneurial dynamism, continuing economic competition, and increasingly volatile labor markets." *Id.* at 4. The realities of the New Economy

forcing states to develop new strategies for creating new economic growth. It is no longer enough for a state to offer huge incentives to recruit a large company to bring in better jobs or a deeper tax base; this kind of “buffalo hunting” is not the prescription for economic salvation.<sup>31</sup> Instead, the states projected to be successful are those that are focusing on developing entrepreneurial companies,<sup>32</sup> as “nearly 70 percent of economic growth is attributable to entrepreneurial activity.”<sup>33</sup> Entrepreneurial firms are a significant source of jobs in the United States. According to the Small Business Administration, small and medium-sized businesses “account for about two-thirds of all new jobs in the U.S. economy each year.”<sup>34</sup>

The fact that Alaska ranks in the bottom half of the states in terms of building capacity for entrepreneurial growth in the *2002 New Economy Index* is a serious detriment to its potential for

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include the following: (1) the importance of new industries and decreasing reliance on traditional industries like manufacturing; (2) a focus on technology in all aspects of business; (3) an emphasis on innovation rather than access to raw materials, transportation, etc.; (4) strategies to create locally-based technological innovation and entrepreneurship; and (5) a labor pool of skilled workers. *Id.*

31. *Id.* at 5. “Buffalo hunting” is the concept of states trying to attract large new companies to relocate to the state, bring jobs, expand the economy, and stimulate growth. *Id.*

32. *Id.*

33. THOM RUBEL ET AL., NAT’L GOVERNORS’ ASSOC., NURTURING ENTREPRENEURIAL GROWTH IN STATE ECONOMIES 6 (2000), available at [www.nga.org/cda/files/ENTREPRENEUR.PDF](http://www.nga.org/cda/files/ENTREPRENEUR.PDF) (citing ANDREW ZACHARAKIS, ET AL., KAUFFMAN CENTER FOR ENTREPRENEURIAL LEADERSHIP, GLOBAL ENTREPRENEURSHIP MONITOR: NATIONAL ENTREPRENEURSHIP ASSESSMENT—UNITED STATES OF AMERICA 8 (1999)).

34. JASON R. HENDERSON, *Are High-Growth Entrepreneurs Building the Rural Economy?* THE MAIN STREET ECONOMIST (Center for the Study of Rural America, Federal Reserve Bank of Kansas City, Kansas City, Mo.) Aug. 2002, at 2. Note that within the broader definition of “entrepreneur,” distinctions are sometimes made between “high-growth” and “lifestyle” entrepreneurs. *Id.* at 2. The latter are entrepreneurs who start businesses to support a certain lifestyle or provide family income; the former are ones who intend to create large, highly visible companies with significant growth potential. *Id.* High-growth entrepreneurs are less common in rural areas because of factors such as the lack of technical or management experience, limited access to technology, or unavailability of venture capital. *Id.* at 2-3. For a more detailed discussion of the different types of entrepreneurs, see also Jason R. Henderson, *Building the Rural Economy with High-Growth Entrepreneurs*, ECONOMIC REVIEW (Federal Reserve Bank of Kansas City, Kansas City, Mo.) Third Quarter 2002, at 48-50, available at <http://www.kc.frb.org>.

overall economic growth.<sup>35</sup> While the state scores relatively high in areas such as manufacturing focusing on exports, online population, and technology in schools, Alaska scores in the bottom quintile in educating its manufacturing workforce, online manufacturers, high tech jobs, industry research and development, “gazelle jobs,”<sup>36</sup> and venture capital.<sup>37</sup> Overall, Alaska ranks thirty-ninth in terms of “innovation capacity,” supporting the conclusion that Alaska is not well-positioned to support entrepreneurial growth necessary to succeed in the New Economy.<sup>38</sup>

### III. VENTURE CAPITAL AS AN ECONOMIC DEVELOPMENT STRATEGY

Venture capital has become an increasingly popular and successful development strategy in the last several years for supporting entrepreneurial development. States that are struggling to strengthen entrepreneurship and want to position themselves to meet the economic realities of the new millennium have found that venture capital, particularly nontraditional venture capital, can bridge the equity gap that prevents many entrepreneurs from starting or expanding their businesses.

#### A. Traditional Venture Capital Models

One of the essential elements to supporting entrepreneurial growth is ensuring that entrepreneurs have access to a variety of risk capital sources.<sup>39</sup> Forms of risk capital have been traditionally defined to include the following:

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35. ATKINSON, *supra* note 30, at 7. Alaska ranks thirty-first out of the fifty states in the composite score, and its ranking has fallen eighteen places since 1999. *Id.*

36. A “gazelle” is often used as a synonym for entrepreneur and is commonly defined as a “firm with sales or revenue growth that exceeds 20 percent per year over a four-year period on a revenue base of approximately \$100,000.” RUBEL ET AL., *supra* note 33, at 9. Gazelles are often distinguished from traditional small businesses: while entrepreneurs import cash, are “precompetitive” in terms of business maturity, and need more technical assistance, traditional small businesses recycle existing dollars and are typically well-established and do not need or want any public assistance. *Id.*

37. ATKINSON, *supra* note 30, at 10-11.

38. *Id.* at 33 (“The innovation capacity indicators . . . measure five things: 1) share of jobs in high-tech industries; 2) scientists and engineers as a share of the workforce; 3) the number of patents relative to the size of the workforce; 4) industry R&D as a share of G[ross] S[tate] P[roduct] [(GSP)]; and 5) venture capital invested as a share of GSP.”).

39. RUBEL ET AL., *supra* note 33, at 9.

(1) *Research and development capital* – funds invested in support of basic research and development; (2) *Innovation capital* – funds invested for applied research to develop new products; (3) *Seed capital* – funds invested to support new and young companies without fully established commercial operations, launch new products, or continue research and product development; (4) *Venture capital* – long-term equity capital invested in rapidly expanding enterprises with an expectation of significant capital gains, often for product roll-out; and (5) *Mezzanine capital* – capital invested with a structure involving subordinated debt, generally in profitable, established companies.<sup>40</sup>

Risk capital is also described in terms of equity capital as opposed to debt finance. Debt finance is characterized by the borrower's specific obligation to repay the loan on a predetermined schedule. In these situations, the lender will be able to recover the outstanding debt if the borrower fails to repay, even if the borrower is forced into bankruptcy.<sup>41</sup> In an equity capital transaction, the individual or institution who provides the funds gains a share of ownership in the business; the equity investor does not have a right to a predetermined repayment schedule or a preferential claim on the assets but is entitled to a share of future profits or losses.<sup>42</sup> Generally speaking, the term "venture capital" is often used to encompass equity deals, when money is invested rather than loaned.<sup>43</sup>

Venture capital provides an entrepreneur with funds needed to get a business off the ground, develop a new product, or grow the business in a new direction.<sup>44</sup> Both successful and struggling companies may need venture capital. Businesses that are doing well may require money for production, marketing, or expansion; those that are struggling can use venture capital to get back on

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40. *Id.* (emphasis added).

41. DAVID FRESHWATER ET AL., RURAL POLICY RESEARCH INST., NONTRADITIONAL VENTURE CAPITAL INSTITUTIONS: FILLING A MARKET GAP 6 fig.1 (2001), available at <http://www.rupri.org/pubs/archive/reports/P2001-11/gap.html>.

42. *Id.*

43. *Equity for Rural America: Community Development Venture Capital*, COMMUNITY REINVESTMENT (Fed. Reserve Bank of Kansas City, Kansas City, Mo.), Fall 1999, at 1 [hereinafter *Equity for Rural America*].

44. For a comprehensive explanation of how venture capital arrangements can be made by entrepreneurs, see generally JOSEPH W. BARTLETT, FUNDAMENTALS OF VENTURE CAPITAL (1999).

track.<sup>45</sup> In both cases, venture capital may also help companies leverage additional sources of financing such as bank loans, which require a prudent ratio of equity to debt.<sup>46</sup>

From the investor's perspective, venture capital is a way to invest in a business for a fixed period of time and then to redeem or sell the investment with a significant return, usually in the goal range of twenty to fifty percent.<sup>47</sup> Because maximizing rate of return is their primary objective, venture capitalists generally invest in a company for three to seven years until they can liquidate their interests through an initial public offering or through a merger or sale of the company.<sup>48</sup> Such liquidation is possible because the funding agreements between investors and investees typically require businesses to relinquish some level of company ownership in return for a capital investment.<sup>49</sup> The investment may take the form of stock or a type of financing instrument that can be converted into stock at a future date.<sup>50</sup> Venture capitalists typically choose to receive preferred stock since it provides preferential treatment upon liquidation or sale of the company.<sup>51</sup>

Traditional venture capital firms are organized as partnerships or as limited liability companies, though they may also be corporations.<sup>52</sup> The investments used to start, or capitalize, a venture capital fund can come from a variety of sources such as pension or endowment funds, foundations, corporations, individual investors, or even the venture capitalists themselves.<sup>53</sup> The types of investors and amount invested depend on the general partner of the fund, the kinds of companies targeted for investment, and the projected fund size.<sup>54</sup> The industry sees investments from \$50,000 to \$20 mil-

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45. *Id.*

46. Kerwin Tesdel, *Venture Capital for Communities*, COMMUNITY INVESTMENTS (Fed. Reserve Bank of San Francisco, San Francisco, Cal.) March 2002, at 24.

47. DAVID L. BARKLEY ET AL., RURAL POLICY RESEARCH INST., EQUITY CAPITAL FOR NONMETROPOLITAN BUSINESSES: AN INTRODUCTION TO ALTERNATIVE SOURCES AND DIRECTORY TO RELATED WEB SITES 8 (1999), available at <http://www.rupri.org/publications/archive/pbriefs/PB99-3/pb99-3.pdf>.

48. *Id.*

49. *Id.*

50. *Id.* Examples of the latter include convertible debentures or debts with warrants. *Id.*

51. *Id.*

52. BARTLETT, *supra* note 44, at 6.

53. BARKLEY ET AL., *supra* note 47, at 8.

54. *Id.* at 9-10.

lion; the most common deals fall within the range of \$500,000 to \$25 million.<sup>55</sup>

Traditional venture capital firms are concentrated in certain parts of the country and tend to focus on particular industries. For example, in 1999, more than sixty-seven percent of all venture capital investments were made in only four states: California, Massachusetts, New York, and Texas.<sup>56</sup> Furthermore, ninety percent of the investments were made in technology-based companies.<sup>57</sup> These statistics indicate that the majority of venture capital investments are being made both in areas and in industries where investments have been made before. Very few deals are being done in rural America or in areas off the beaten, high-tech track.<sup>58</sup> Places like Alaska are often left with limited access to the fundamental source of improving entrepreneurship opportunities.

Some would argue that the reason for the lack of venture capital in the non-metropolitan marketplace is purely a matter of economics; companies in non-metropolitan markets “simply do not offer competitive rates of return,” and therefore do not get funded.<sup>59</sup> In other words, these individuals suggest that the reason many small businesses fail to attract funding is because of their failure to offer the same risk-adjusted rate of return that can be earned on other investments.<sup>60</sup> This view fails to recognize some of the specific hurdles to rural equity, which include both the nature of the rural capital market itself and the difficulties in applying the traditional model of venture capital financing to the unique characteristics of the rural marketplace.

The nature of the rural capital market system itself often bars rural businesses from access to sources of debt and equity financ-

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55. *Id.* at 8.

56. Deborah M. Markley, *Financing the New Rural Economy*, PROCEEDINGS, (Fed. Reserve Bank of Kansas City, Kansas City, Mo.) Sept. 2001, at 72, available at <http://www.kc.frb.org/Publicat/Exploring/RC01Mark.pdf-10-15-01>. In fact, forty percent were made in Silicon Valley alone. FRESHWATER ET AL., *supra* note 41, at 3.

57. FRESHWATER ET AL., *supra* note 41, at 3.

58. For the purposes of this analysis, this Note will assume that the state of Alaska as a whole would meet the general definition of “rural” or non-metropolitan.

59. Matt P. McClorey, *Are State-Sponsored Venture Capital Funds Necessary for the Development and Growth of the Kansas Economy?*, 7 KAN. J.L. & PUB. POL’Y 152, 160 (1998) (using the state of Kansas as a model for demonstrating that there is no “shortage” of venture capital and stating that an offer of competitive return rates by companies would result in an increase in capital provided by investors).

60. FRESHWATER ET AL., *supra* note 41, at 7.

ing. In terms of debt financing, the consolidation or merger of local banks into larger national “money center” institutions in the past decade has led to a decrease in the number of business loans being made in rural communities.<sup>61</sup> Consolidation has also led to a decreased emphasis on relationship-based lending and an increased focus on transaction-based lending.<sup>62</sup> Relationship-based lending relies on information the banker has gained through contacts with the borrower made during the deposit relationship, allowing a banker to supplement limited financial information and still make a deal.<sup>63</sup> Relationship-based lending can often be more helpful for a business owner who is trying to start a business in a sector unfamiliar to the banker or for a business owner who does not have much of a track record.<sup>64</sup> Because relationship-based lending relies on information the banker has gained through contacts with the borrower, a banker may be able to loan more to business entrepreneurs who are unable to supply all of the financial information normally required of unknown parties.<sup>65</sup> Transaction-based lending, however, relies on quantitative data rather than qualitative data—credit scoring and financial statements instead of personal experience.<sup>66</sup> Thus, the increase in transaction-based lending and the decrease in relationship-based lending in rural communities may bar entrepreneurs in rural communities from obtaining debt finance.<sup>67</sup>

On the equity side, some economists believe that the lack of well-developed rural venture capital markets may be caused by “market failures that result from imperfect information and high transaction costs.”<sup>68</sup> High transaction costs, in turn, limit the deal flow<sup>69</sup> of venture capital deals in rural communities. Rural communities are often characterized by low-tech, slow-growth sectors: sectors that do not generate the number of deals or high rates of re-

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61. See Markley, *supra* note 56, at 70-71.

62. *Id.* at 71.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.* at 72.

68. *Id.*

69. “Deal flow” is the number of potential investment opportunities available at a given time. David L. Barkley et al., *Establishing Nontraditional Venture Capital Institutions: The Decision Making Process* 6, Rural Policy Research Institute (2001), available at <http://www.rupri.org/publications/archive/reports/P2001-11/decision.html>.

turn that typically attract traditional venture capital investors.<sup>70</sup> The limited number of deals leads to higher costs per investment for both identifying prospective deals and maintaining the necessary relationship with particular companies.<sup>71</sup> This is because venture capital firms are often characterized by a high level of involvement in the businesses in which they invest.<sup>72</sup> Thus, in addition to economic considerations, the hand-holding nature of the venture capital business is compromised if the venture capital firm is geographically removed from the business in which it is investing.<sup>73</sup>

Several other factors account for the lack of traditional venture capital investing in rural areas. The limited number of opportunities for existing deals may make rural venture capital investing appear less attractive to traditional funds.<sup>74</sup> In addition, rural business owners may be reluctant to give up ownership or control in exchange for venture capital equity,<sup>75</sup> instead preferring to keep the business in the family by transferring ownership to the next generation.<sup>76</sup> This means that traditional venture capital exit strategies like initial public offerings may not be possible. Finally, rural areas may not have the business service infrastructure—including well-trained attorneys, accountants, bankers, and business consultants—required to support venture capital investing.<sup>77</sup>

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70. *Id.* at 73-74; *see also* Equity for Rural America, *supra* note 43, at 2.

71. Markley, *supra* note 56, at 74; *see also* David L. Barkley et al., *Nontraditional Sources of Venture Capital for Rural America*, 16 RURAL AMERICA 1, 19 (May 2001), available at <http://www.ers.usda.gov/publications/ruralamerica/ra161/ra161d.pdf> (“‘Small market’ areas such as non-metro communities and rural areas are especially overlooked by traditional venture capital firms because of the relatively high cost of finding or creating deals and managing the investments.”).

72. Fund managers may be intimately involved in the financing of the deal, may serve on the board of directors, and may give management or financial advice to the business. The fund may even take over the management of the business if it seems necessary to save the company or protect the fund’s investment. *Equity for Rural America*, *supra* note 43, at 1.

73. William Amt, *Looking for Venture Capital in Rural America*, 12 ECONOMIC DEVELOPMENT DIGEST NUMBER 7, JUNE 2001 (NADO Research Foundation, Washington, D.C.), available at <http://www.nado.org/pubs/june6.html>.

74. Markley, *supra* note 56, at 74.

75. Barkley et. al., *supra* note 71, at 20; *Equity for Rural America*, *supra* note 43, at 2.

76. Barkley, *supra* note 71, at 20; Markley, *supra* note 56, at 74.

77. FRESHWATER ET AL., *supra* note 41, at 4.

## B. Nontraditional Venture Capital May Provide a Better Solution for Rural Communities

As discussed above, venture capital opportunities are fewer and smaller in rural areas. More time may be required before available opportunities to create a viable return on investments become available, and alternative methods of management or exit strategies may be required. For these reasons, traditional venture capitalists often do not find it worthwhile to conduct business in rural areas when there are “better” deals to be made elsewhere. However, these flaws in the rural capital market system and barriers to rural financing do not mean that venture capital financing is impossible. In fact, success of nontraditional venture capital funds in rural areas indicates that equity deals can be done successfully in rural areas under the right set of circumstances.<sup>78</sup>

Nontraditional venture capital funds bridge the equity gap that exists in communities unserved or underserved by traditional venture capital firms. As the name itself suggests, nontraditional funds typically operate outside the scope of traditional funds either in terms of geography or business sector. Nontraditional funds may be located in small market areas such as nonmetropolitan areas or rural communities and typically have specific geographic restrictions on potential investments.<sup>79</sup> The restrictions may be so narrow that the fund only invests in a particular community or may be broad enough that the fund can do business across an entire region.<sup>80</sup> Furthermore, nontraditional funds tend to focus on industries outside of, or in addition to, the high-tech sector.<sup>81</sup>

Perhaps the biggest difference between traditional and nontraditional venture capital funds is the difference in financial goals. While traditional venture capital funds expect an annual return on investment in excess of thirty to forty percent, nontraditional funds expect more modest returns,<sup>82</sup> in part because they have social or economic purposes in mind in addition to maximizing the financial

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78. See generally DAVID L. BARKLEY ET AL., RURAL POLICY RESEARCH INST., ESTABLISHING NONTRADITIONAL VENTURE CAPITAL INSTITUTIONS: LESSONS LEARNED (2001), available at <http://www.rupri.org/publications/archive/reports/P2001-11/lessons.html>.

79. *Id.* at 3.

80. *Id.* at 3-4. For example, one fund focuses only on Appalachia; another will make investments anywhere east of the Mississippi River. *Id.*

81. *Id.*

82. *Id.* Most nontraditional funds are willing to take less than traditional funds. For example, they may take less than 30 percent because they have additional social goals beyond pure financing. *Id.* at 12.

rate of return.<sup>83</sup> The alternative goals may include creating jobs for low or moderate income individuals, building companies that are owned by women or minorities, or ensuring that local workers achieve particular wage or benefit levels.<sup>84</sup> The combination of financial and economic development goals is commonly referred to as a double or dual bottom line.<sup>85</sup>

Because of the lowered rate of return and the emphasis on the double bottom line, nontraditional venture capital funds tend to attract different types of investors than traditional funds.<sup>86</sup> In particular, nontraditional funds are typically capitalized by funding sources that value social and economic returns, or are willing to be a more patient source of investment capital.<sup>87</sup> Potential sources of funds might include public state funds, foundation support, or banks that are seeking Community Reinvestment Act credit.<sup>88</sup> Nontraditional funds may also be able to leverage additional funds through federal sources. For example, the Small Business Administration (“SBA”) regulates both the Small Business Investment Company (“SBIC”) Program and the New Markets Venture Capital (“NMVC”) Program, and the Treasury Department manages the Community Development Financial Institution (“CDFI”) Fund.<sup>89</sup>

The type of investors willing or able to capitalize a nontraditional fund frequently determines what kind of fund structure will work in a particular area.<sup>90</sup> Some of the common types of nontraditional venture capital institutions are: (1) publicly funded, publicly managed venture capital funds; (2) publicly funded, privately man-

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83. Markley, *supra* note 56, at 75.

84. JULIA SASS RUBIN, COMMUNITY DEVELOPMENT VENTURE CAPITAL ALLIANCE, COMMUNITY DEVELOPMENT VENTURE CAPITAL: A REPORT ON THE INDUSTRY 17 (2001). These types of investment criteria are also referred to as social screens. *Id.*

85. *Community Development Venture Capital: The Double Bottom Line*, COMMUNITY INVESTMENTS (Fed. Reserve Bank of San Francisco, San Francisco, Cal.), Fall 1998, at 1, available at <http://www.frbsf.org/publications/community/investments/cra98-4/page3.html> (Fall 1998) [hereinafter *The Double Bottom Line*].

86. *Id.* at 4.

87. DEBORAH MARKLEY ET AL., RURAL POLICY RESEARCH INSTITUTE, RURAL EQUITY MARKET INNOVATION: A NATIONAL SNAPSHOT 6-7, (1999), available at <http://www.rupri.org/publications/archive/old/finance/p99-1/p99-1.pdf>; see also Markley, *supra* note 56, at 75. Being a patient source of capital means that the investor is willing to wait longer to receive its return on investment than the typical venture capital investor who expects a return in three to seven years.

88. Markley, *supra* note 56, at 77-78.

89. *Id.* at 77.

90. MARKLEY ET AL., *supra* note 87, at 9.

aged venture capital funds; (3) certified capital companies (“CAPCOs”); (4) small business investment companies (“SBICs”); and (5) community development venture funds (“CDVCs”).<sup>91</sup> Each of these institutions has its own strengths and weaknesses. States looking to develop one or more of these programs should look closely at how the comparative advantages and disadvantages might apply in the context of the state’s unique qualities and goals.<sup>92</sup>

1. *Publicly Funded, Publicly Managed.* These programs are usually set up with the goal of promoting economic development or improving access to venture capital.<sup>93</sup> They are most often managed by employees of state agencies, such as the Department of Commerce, or quasi-public organizations.<sup>94</sup> The boards of directors, who are responsible for making investment decisions and providing oversight, are typically appointed by the governor.<sup>95</sup> These types of funds are most often capitalized by public funds generated from state appropriations or bond sales. Because of the substantial reliance on state funding, these funds come with restrictions that all or part of the investments be made within the state and that the investments comply with the state’s goal for economic development.<sup>96</sup>

Advantages of publicly funded, publicly managed funds include the state’s ability to direct its funding toward particular policy objectives or industries.<sup>97</sup> This may ensure that economic and social impacts are more likely to be considered in investment decisions.<sup>98</sup> On the other hand, however, these funds often face substantial political pressure to make investments in specific areas or specific businesses that might not otherwise be considered good investments.<sup>99</sup> In addition, publicly managed firms may not be able to attract the most qualified or competent fund managers, and private venture capital firms may not be willing to co-invest with these types of funds because of the perception of the funds as over-politicized and less responsive to private sector investors.<sup>100</sup> This

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91. BARKLEY ET AL., *supra* note 71, at 22-23; BARKLEY ET AL., *supra* note 78, at 4-5.

92. BARKLEY ET AL., *supra* note 78, at 6.

93. *Id.* at 5.

94. *Id.*; BARKLEY ET AL., *supra* note 71, at 21.

95. BARKLEY ET AL., *supra* note 71, at 21.

96. *Id.*

97. *Id.* at 24.

98. *Id.*

99. *Id.*

100. *Id.*

may limit the fund's ability to invest in a broader range of opportunities.<sup>101</sup> A final barrier to receiving state investment is the fact that some state constitutions do not allow state agencies to make equity investments.<sup>102</sup>

2. *Publicly Funded, Privately Managed.* Like publicly funded, publicly managed funds, publicly funded but privately managed funds typically receive the bulk of their capitalization from public sources. Unlike their publicly managed counterparts, however, privately managed funds are typically organized with a slightly different purpose. The purpose of these funds is often 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.<sup>103</sup> Thus, these funds tend to focus more on maximizing profits and less on social or economic development objectives.<sup>104</sup> While the state may sacrifice some control for private management, it gains more limited financial risk and may receive better economic returns.<sup>105</sup>

Capitalization of this type of fund has varied among different programs. Some have obtained state funding with a requirement for a private match or provided additional inducements to encourage private investment.<sup>106</sup> For example, one fund was able to guarantee private investors that they would receive a minimum return on investment before the state received its return. In another instance, the State did not require any return on its investment, thereby providing private investors with significant leverage or premium on their investments.<sup>107</sup>

While publicly funded, privately managed funds have many advantages that their publicly managed counterparts lack — such as less political pressure, greater opportunity to attract and assist experienced managers, and greater leverage for private capital —

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101. *Id.* However, sometimes using state funding is the best way of getting a fund off the ground. A fund may later be able to move away from its reliance on the state if it feels that the goals of the institution have changed. For example, a Kansas fund is currently in the process of buying out the state's interest in the fund so it can focus on investment deals with a higher potential for return on investment. DEBORAH M. MARKLEY ET AL., RURAL POLICY RESEARCH INSTITUTE, CASE STUDIES 32-37 (2001).

102. BARKLEY ET AL, *supra* note 70, at 24. Alaska's constitution does not explicitly mention equity investments.

103. *Id.* at 22.

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

they are not without disadvantages.<sup>108</sup> Because of the increased focus on rate of return, these funds may not address a state's economic development concerns and may lack sufficient public subsidies to make venture capital institutions viable in rural communities.<sup>109</sup> Even so, the combination of public funding and private management is considered to be one of the most effective in bringing venture capital financing to rural communities, particularly in areas that require a significant amount of early stage investing.<sup>110</sup>

Regardless of whether publicly funded venture capital funds are privately or publicly managed, there are several public funding issues that individuals trying to create new funds should consider.<sup>111</sup> Public funding should be given in one lump sum rather than as an annual appropriation over a period of time.<sup>112</sup> While it may be more difficult to convince a state to make a large lump sum investment, the "vagaries of the political process" often make annual appropriations more trouble than they are worth.<sup>113</sup> Funds receiving annual appropriations may make suboptimal investment decisions because they feel pressure to use the appropriation whether or not there are good deals available.<sup>114</sup> Furthermore, because investment failures are more likely to occur before successes, the political will to continue disbursing appropriations can be compromised, thereby jeopardizing the success of both present and future deals.<sup>115</sup> And finally, as mentioned previously, an additional problem with accepting public funds may be the state's restrictions on geographic or economic development objectives.<sup>116</sup> These restrictions may limit the fund's ability to generate enough deal flow to keep the fund going and may make it impossible for the fund to partner with other investors outside the state.<sup>117</sup>

3. *Certified Capital Companies ("CAPCOs")*. Another model for state-assisted venture capital development is the use of CAPCOs. CAPCOs are privately funded, privately managed venture capital institutions, created by state enabling legislation, and

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108. *Id.* at 24.

109. *Id.*; BARKLEY ET AL, *supra* note 69, 12.

110. MARKLEY ET AL, *supra* note 87, at 16.

111. BARKLEY ET AL., *supra* note 109, at 12.

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.*

117. *Id.*

capitalized by insurance companies, which pursue maximized internal rates of return while meeting a state's regulatory requirements.<sup>118</sup> The legislation typically provides that insurance companies will receive 100 percent state tax credits over ten years on premium taxes in exchange for their investment.<sup>119</sup> The insurance companies that provide the capitalization are also guaranteed a return on their investment.<sup>120</sup> To maintain certification and qualification for tax credits, CAPCOs are generally required to invest a certain percent of funds in businesses within the state or in certain sectors.<sup>121</sup>

CAPCOs often appear attractive to states trying to support venture capital development because the states do not have to take money out of their general budgets and do not have to raise funds through bond sales.<sup>122</sup> CAPCOs also have the advantage of being able to raise substantially more capital in a much faster time frame than funds capitalized by other sources of public funds, and—like privately managed public funds—they make it easier to attract private co-investors and offer more competitive compensation for managers.<sup>123</sup> Further, unlike most venture capital institutions where capitalized investments are fully at risk, CAPCO investors assume little or no risk.<sup>124</sup>

While CAPCOs appear very attractive on the surface, they have been widely criticized in recent years for being a boon to insurance companies while providing lesser benefits to states or small businesses.<sup>125</sup> First, CAPCOs are considered the most expensive model of venture capital, particularly when compared to how much

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118. BARKLEY ET AL., *supra* note 78, at 6.

119. *Id.*; see also ROBERT G. HEARD ET AL., NATIONAL GOVERNORS' ASSOCIATION, GROWING NEW BUSINESSES WITH SEED AND VENTURE CAPITAL: STATE EXPERIENCES AND OPTIONS 14 (2000), available at <http://www.nga.org/cda/files/VENCAPITAL.PDF>.

120. CHIP COOPER ET AL., UNDERSTANDING CAPCOs 4, NATIONAL ASSOCIATION OF SEED AND VENTURE FUNDS (Oct. 2001), available at <http://www.nasvf.org>.

121. *Id.*

122. David L. Barkley et al., *Certified Capital Companies (CAPCOs): Strengths and Shortcomings of the Latest Wave in State-Assisted Venture Capital Programs*, ECON. DEV. QUARTERLY 350, 360, Nov. 2001.

123. *Id.* at 360-61.

124. COOPER ET AL., *supra* note 120, at 6. Lack of risk taking means that CAPCO managers have little incentive to make prudent investment decisions since none of their assets are at risk and the institution's assets have a guaranteed rate of return. See Barkley et. al., *supra* note 122, at 362.

125. See Barkley et. al., *supra* note 120, at 362; COOPER ET AL., *supra* note 120, at 10.

states typically spend on other economic development strategies.<sup>126</sup> Second, state legislators often receive very biased information about the relative strengths and weaknesses of CAPCOs because the insurance/CAPCO industry itself is often the one lobbying for new programs or additional resources; this may lead to legislation that is ill-suited for a state's true economic development needs.<sup>127</sup> Finally, CAPCOs tend to do very little seed or start-up investing.<sup>128</sup>

4. *Small Business Investment Companies ("SBICs")*. SBICs are privately owned for-profit investment institutions licensed and regulated by the SBA.<sup>129</sup> SBICs leverage private capital with borrowed federal funds to make equity investments.<sup>130</sup> An SBIC may be organized as a corporation, limited partnership, or limited liability company,<sup>131</sup> and is typically owned by a small group of local investors or by a commercial bank.<sup>132</sup> SBICs are required to have a minimum private capital reserve of \$2.5 million to be licensed and \$5 million to leverage SBA funds (\$10 million if the SBIC intends to issue securities guaranteed by the SBA).<sup>133</sup> SBA regulations also require that SBICs invest only in "small" companies and must maintain minimum standards for qualified fund managers.<sup>134</sup>

Advantages of SBICs include the ability to leverage private capital with federal funding, which can be very attractive to poten-

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126. Barkley et al., *supra* note 122, at 361. For example, the five states that have implemented CAPCO programs have committed \$1.25 billion in tax credits, which is considered an enormous allocation of public funds when compared to other commitments to high tech, rural, or minority business development. COOPER ET AL., *supra* note 120, at 5.

127. See Barkley et al., *supra* note 122, at 362.

128. *Id.*

129. See 15 U.S.C. § 661 *et seq.* (2003).

130. BARKLEY ET AL., *supra* note 78 at 6, 9; see 15 U.S.C. § 661.

131. 15 U.S.C. § 681(a).

132. Overview: The SBIC Program, at <http://www.sba.gov/INV/overview.html> (last visited Oct. 27, 2003).

133. 15 U.S.C. § 682(a).

134. "Small" companies are ones with a net worth less than or equal to \$18 million and an average net income not exceeding \$6 million, though industries with large average firm sizes have higher standards. BARKLEY ET AL., *supra* note 47, at 2. The SBA also considers the experience of the company's managers and owners. 15 U.S.C. § 683(a)(3)(B). Management experience, or "track record," is a key consideration for SBA approval. Joseph W. Bartlett, *Government-Enhanced Equity Available for Investment in Traditional Venture Capital and Buyouts: The New SBIC Participating Securities Program*, 1994 COLUM. BUS. L. REV. 589, 610 (1994).

tial private investors.<sup>135</sup> There is also a lot of flexibility in the SBIC program to invest in different industries or in business in various stages of development, depending on the investment policy or financing preference of individual SBIC management teams.<sup>136</sup> SBICs are also thought to have potential for exceptional returns from venture capital investments in small businesses and are attractive because of their flexible investment structures and ability to obtain long-term funds at favorable rates from the federal government.<sup>137</sup> Bank investors find SBICs particularly attractive because they allow for equity investments free of many of the restrictions imposed by current banking law.<sup>138</sup> A significant disadvantage, however, may be the difficulty in finding enough private investors to meet the SBA's minimum capitalization requirements in the first place.<sup>139</sup> This is considered the primary reason why SBICs are so uncommon in nonmetropolitan or rural areas.<sup>140</sup> In addition, the immediate debt repayment required by SBIC government loans may make SBICs shy away from doing riskier seed or early-stage investing because of high delinquency rates.<sup>141</sup>

5. *Community Development Venture Capital ("CDVC") Funds.* A growing sector of the nontraditional venture capital market is in the area of CDVC funds.<sup>142</sup> These funds are characterized by their attempt to maximize return on investment within the parameters of core community development goals.<sup>143</sup> Most CDVCs are mission-oriented and believe that one of the primary mechanisms for alleviating poverty in distressed communities is to help create access to high-quality jobs.<sup>144</sup>

Apart from their commitment to the same broad goal, CDVCs vary significantly from fund to fund or state to state, particularly in

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135. BARKLEY ET AL., *supra* note 47, at 3.

136. *Id.*

137. *Small Business Investment Companies*, at <http://www.evwm.com/practiceareas/businessfinance/manuals/sbicintr.htm>.

138. *Id.*

139. BARKLEY ET AL., *supra* note 78, at 9.

140. *Id.* at 6. A Rural Policy Research Institute study of nontraditional venture capital institutions found that only one SBIC is located in a rural area and few others have a significantly rural focus. *Id.*

141. BARKLEY ET AL., *supra* note 47, at 3.

142. *The Double Bottom Line*, *supra* note 84, at 4.

143. BARKLEY ET AL., *supra* note 47, at 7.

144. Julia Sass Rubin, *Organizations on the Institutional Cusp: The Origins and Behaviors of Community Development Venture Capital Funds 70-71* (2001) (unpublished Ph.D. dissertation, Harvard University) (on file with author).

terms of size and investment objective.<sup>145</sup> Generally speaking, a significant portion of CDVC capital has come from banks or other financial institutions; a recent study of the industry found that when all CDVC funds are taken into account, fifty-eight percent of the capital for funds created within the past four years had come from these sources.<sup>146</sup> Other sources of capital include foundation support in the form of program-related investment as well as state and federal funding.<sup>147</sup>

The CDVC model has several strengths that make this type of fund particularly appropriate for targeted economic development.<sup>148</sup> As the name itself suggests, CDVCs intentionally seek out community economic development objectives. These funds may focus on social goals such as job creation or may target particular geographic areas, business stages, or types of industries that are often overlooked by traditional venture capitalists.<sup>149</sup> CDVCs are also more likely than other venture capital funds to consider exit strategies that benefit the business owners or workers instead of focusing entirely on maximizing return on investment. For example, some CDVCs have tried to use employee stock ownership plans or management buybacks, strategies that take longer periods of time and are not as lucrative but provide more benefits to the community.<sup>150</sup> Finally, because CDVCs are often heavily subsidized, they are able to provide extensive technical assistance to their portfolio companies, a factor that significantly improves success rates.<sup>151</sup>

Creating a fund that has a double bottom line is often a tricky task. The CDVC model may experience difficulty raising capital and reaching scale, difficulty attracting experienced talent, and potentially prohibitive cost of operation.<sup>152</sup> For example, CDVC funds often have a hard time attracting experienced managers to operate the fund both because of the experience required for a fund manager and the salary such a manager would likely de-

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145. See generally RUBIN, *supra* note 84.

146. *Id.* at 11. One reason for the increase in financial institution investing is attractiveness of using CDVC investments as a way of meeting Community Reinvestment Act obligations. *Id.*

147. *Id.*

148. BARKLEY ET AL., *supra* note 78, at 8-9.

149. *Id.*

150. RUBIN, *supra* note 84, at 15.

151. *Id.* at 17-18.

152. *The Double Bottom Line*, *supra* note 84.

mand.<sup>153</sup> There are several reasons why CDVCs are so expensive to operate. First, the average size of the investment is usually small, but the cost of a smaller investment is often the same as the cost of a larger investment. Second, CDVC funds are often even more involved in the management of their investee businesses and provide more technical assistance than traditional funds. Therefore, many CDVC funds require some sort of subsidy to ensure that the double bottom line objectives can be met without unduly reducing the investment earnings.<sup>154</sup> Finally, CDVCs may also find it difficult to maintain sufficient investment diversification because of limited deal flow.<sup>155</sup>

#### IV. IMPLEMENTING A NONTRADITIONAL VENTURE CAPITAL MODEL IN ALASKA

As the economic growth statistics suggest, Alaska needs to re-focus its economic development effort to help its citizens deal with the realities of the New Economy. To this end, Alaska should consider supporting the development of a nontraditional venture capital fund that focuses on increasing entrepreneurship. After a comprehensive study of nontraditional venture capital funds, the Rural Policy Research Institute (“RUPRI”) has identified seven steps that new fund organizers should consider when creating a nontraditional venture capital fund: (1) recognize the reason for creating the institution; (2) conduct market analysis to estimate deal flow or potential for creating deal flow; (3) articulate goals and objectives for the fund; (4) select an appropriate size and management structure; (5) identify sources of funds to capitalize the institution; (6) select the legal and organizational structure; and (7) manage investment activity.<sup>156</sup>

Using RUPRI’s outline as a general guide, the following part of this Note will analyze the reasons why Alaska should participate in the creation of a nontraditional venture capital fund as an economic development strategy and will consider the steps that must be taken to get a new fund off the ground. In particular, this Part will consider the need for venture capital in Alaska, what goals or objectives such a fund should have, how the fund could be capital-

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153. *Id.* at 11. A traditional venture capital fund manager typically receives an annual management fee based on two to three percent of the fund capital in addition to a predetermined percentage of the profit or earned interest on the fund’s investments. This structure encourages traditional fund managers to maximize the rate of return. BARKLEY ET AL., *supra* note 78, at 3.

154. *The Double Bottom Line*, *supra* note 84, at 10.

155. *Id.* at 5.

156. BARKLEY ET AL., *supra* note 109, at 3.

ized, and how it should be managed. This Part will conclude that Alaska is well-positioned to create a nontraditional venture capital fund that takes a blended approach to achieving both a return on investment and an impact on economic development.

#### A. There is a Need for Nontraditional Venture Capital in Alaska.

Broad statistical indicators suggest that Alaska needs to improve its capital infrastructure to support small business and entrepreneurial development,<sup>157</sup> and individuals in Alaska working to stimulate business development acknowledge that the need is great. Several directors of nonprofit organizations in Alaska that focus on building entrepreneurship have found that Alaskan entrepreneurs face limited opportunities for obtaining equity financing to start or grow their businesses.<sup>158</sup> A more comprehensive venture capital market in the state could fill this gap and give entrepreneurs the support they need to grow their businesses while providing the state with a more stable and prosperous economic base.<sup>159</sup>

While no formal market study has been conducted in Alaska, Jamie Kenworthy, the former Executive Director of the Alaska Science and Technology Foundation (“ASTF”) conducted an informal market study to determine what particular financing gaps exist in Alaska.<sup>160</sup> He interviewed ten individuals who represent a

157. See discussion *infra* Part I.

158. Telephone interview with Deborah Marshall, Executive Director, Alaska InvestNET (Nov. 18, 2002); telephone interview with Jamie Kenworthy, former Executive Director, Alaska Science and Technology Foundation (Dec. 16, 2002) [hereinafter Kenworthy interview]. Alaska InvestNet is a statewide non-profit corporation that provides technical assistance to help entrepreneurs gain access to business development resources and potential investors. See generally Alaska InvestNET, at <http://www.alaskainvestnet.org> (last visited Oct. 21, 2003). Alaska Science and Technology Foundation (ASTF) was a state agency that was created in 1988, pursuant to Alaska Statutes section 37.17.010, to improve the state’s science and engineering capabilities. Due to budget shortfalls, the agency was defunded in the spring of 2003. Richard Richtmyer, *End Nears for State Science Agency; Alaska Science and Technology Foundation Will Cease to Exist after June 30*, ANCHORAGE DAILY NEWS, May 30, 2003, at D1.

159. Kenworthy interview, *supra* note 156; see also Deborah Marshall, *New Ideas Can Help Alaska’s Future: Creating an Entrepreneurial Culture in Alaska*, available at <http://www.alaskainvestnet.org/interns-article3.html> (last visited Oct. 24, 2003) (discussing the lack of an entrepreneurial culture in Alaska and strategies for improving access to capital and business development assistance).

160. Letter from Jamie Kenworthy, former Executive Director, Alaska Science and Technology Foundation, to Board of Directors, Alaska Science and Technology Foundation (Aug. 2000) (on file with author) [hereinafter 2000 Letter]; Kenworthy interview, *supra* note 156.

variety of organizations that have done or tried to do venture capital-type equity deals in the past. Some of the questions included: (1) Are there deals that could be financed in Alaska but have not been? (2) If not, why not? Was it because of the deal size, the business sector, or level of risk? (3) What are some examples of deals that have not been financed but should have been? (4) What level of capital is needed for deals that are being left un-done? And (5) If a new venture fund were started, what characteristics should it have in terms of investment type, management structure, organization structure, use of public funds, etc.<sup>161</sup> Based on the results of this study, Kenworthy argues that Alaska has a sufficient deal flow to justify creating a new venture capital institution in the state.<sup>162</sup>

In particular, the Alaska market study indicates that the majority of potential deal flow would come from manufacturing (*e.g.*, seafood, forest products, etc.), resource development, and telecommunications sectors.<sup>163</sup> Other potential deals might include technology or tourism-based businesses.<sup>164</sup> In addition, the market analysis demonstrates a need for both equity and blended debt/equity deals. Many of the individuals surveyed also noted a need for a fund that has the capacity to make larger deals in the \$1 million plus range or a willingness to provide mezzanine capital.<sup>165</sup>

While Kenworthy's survey provides a good overview of the current market in Alaska, it may not be sufficiently persuasive to encourage potential investors to put up capital. Furthermore, largely anecdotal evidence from only ten individuals is an insufficient basis for determining appropriate investment goals. Thus, this Note recommends that individuals or organizations planning to start a new fund first commission a professional market study. To raise the funds for this research, this Note recommends that the individuals and organizations planning to organize and operate the new fund should first create a nonprofit corporation that could ob-

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161. Survey from Jamie Kenworthy, Executive Director, Alaska Science and Technology Foundation (2000) (on file with author).

162. 2000 Letter, *supra* note 160.

163. *Id.*

164. *Id.*

165. *Id.* Many of the surveyed individuals felt that ASTF already serves the needs of businesses that are seeking seed capital and that Alaska Growth Capital fills the gap for other start-up investors. *Id.* While this may be true, Kenworthy acknowledges that he personally knows all the individuals surveyed and that his relationship with them may have influenced their responses. *Id.* Because ASTF focuses entirely on technology businesses and Alaska Growth Capital does mostly rural deals, this note suggests that seed and start-up capital deals are probably being missed in the current market. *Id.*

tain funds from a foundation to conduct the market study. Using the structure of a nonprofit corporation could also be useful in later stages of the fund's creation, particularly to leverage resources to provide technical assistance.

#### B. The Goals and Objectives for a Nontraditional Venture Capital Fund.

After conducting a systematic market study, Alaska's stakeholders will need to articulate what goals the new fund will seek to achieve, particularly regarding financial return. Generally speaking, the unique nuances of the nontraditional venture capital model have led to different schools of thought on the trade-off between economic development benefit and rate of return.<sup>166</sup> Some believe that funds should focus on making investments in successful companies with a high growth potential.<sup>167</sup> This group believes that economic development benefits will automatically flow from making companies stronger and more successful.<sup>168</sup> Others believe that economic development goals must be clearly articulated and pursued from the beginning to ensure that particular outcomes such as job creation, wage levels, and job quality are actually achieved.<sup>169</sup> Because the majority of nontraditional venture capital funds have not been operating for an extended period of time, there is a lack of quantitative data regarding the long-term benefits or relative merits of either strategy. Fund managers and researchers from both schools would agree, however, that determining which model to pursue is essential at the earliest stages of creating a new nontraditional fund, particularly to ensure that fund organizers and investors are pursuing the same ends.<sup>170</sup>

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166. See MARKLEY ET AL., *supra* note 86, at 7 (explaining opposing schools of thought regarding investment goals for nontraditional venture capital funds).

167. *Id.*

168. *Id.*

169. *Id.* For example, the Kentucky Highlands Investment Corporation prefers not to use many restrictions for its investments because of the limited deal flow in its nine-county Appalachian region; it also believes that *any* job creation is beneficial in regions such as the one it serves, regions characterized by very high unemployment and a large unskilled population. On the other side of the spectrum, Maine's Coastal Ventures, LP (which invests in the entire state) prefers to invest in companies with environmentally friendly practices and socially progressive managers; it also requires companies to attempt to hire workers from specific populations and to provide them with specific types of benefits. RUBIN, *supra* note 84, at 17.

170. MARKLEY ET AL., *supra* note 86, at 8.

According to Kenworthy's market study, none of the individuals who were interviewed thought that a new fund should mix economic development objectives with a focus on obtaining a significant return on investment, though one individual noted that some sort of subsidy for technical assistance would be needed.<sup>171</sup> This view was based in part on the perception that funds that mix objectives are always unsuccessful.<sup>172</sup> As the previous analysis in Part II suggests, however, creating a fund that seeks to achieve a more modest return on investment while contributing to economic development objectives can, in fact, be done. Considering that Kenworthy and others already acknowledge that traditional venture capital returns of thirty percent or more and traditional exit strategies like an initial public offering are unrealistic in the current Alaska market,<sup>173</sup> this Note recommends that the developers of Alaska's new fund reconsider the possibilities for incorporating economic development goals with a seven to fifteen percent return on investment.

For example, one obvious investment objective of a new fund should be to create a majority of deals within the state. This type of geographic restriction will influence the qualifications of managers or staff the fund hires (*i.e.*, ones who have experience in Alaska). However, a new Alaska fund should not focus exclusively within the state; it should make sure it can participate in deals in other regions. This serves two purposes. First, this strategy encourages traditional or nontraditional funds from outside Alaska to co-invest in Alaska-based deals if they think the Alaska fund may one day do the same for one of their deals. Second, this strategy will provide an opportunity for the Alaska fund to boost its deal flow or balance the risk in its portfolio.<sup>174</sup>

An additional goal of a new Alaska fund should be improving the entrepreneurial culture within the state by providing technical assistance.<sup>175</sup> Nontraditional venture capital funds facing a limited number of potential investment opportunities (because of geographic or social restrictions) may be more likely to invest in companies with limited management experience than traditional

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171. 2000 Letter, *supra* note 160.

172. *Id.*

173. Kenworthy interview, *supra* note 158.

174. Telephone interview with Deborah Markley, Principal, Policy Research Group (Dec. 4, 2002).

175. See Marshall, *supra* note 157 (discussing Alaska's historical lack of an entrepreneurial culture and the need for new business owners to receive hands-on management assistance in addition to financing sources such as venture capital).

funds.<sup>176</sup> To compensate for the lack of experience within the business, the venture capital fund may need to offer significant amounts of technical assistance to increase the companies' level of knowledge and market readiness.<sup>177</sup> Obviously, this can be a very expensive proposition. Some CDVCs have developed innovative approaches to offset the costs of technical assistance. For example, a fund in California requires potential investees to go through a Business Advisory Program run by experienced volunteer business professionals.<sup>178</sup> An additional benefit of improving technical assistance may be the generation of increased deal flow to an area.<sup>179</sup> Within the context of Alaska, the lack of quality of business management is a current barrier to entrepreneurial success; technical assistance can provide training for less competent or experienced managers.<sup>180</sup>

### C. Creating the Fund: Capitalization.

While the optimal capitalization for a venture capital fund will depend on the fund's goals, structure, and sources of funding, the amount of capitalization should also be related to the potential deal flow.<sup>181</sup> Successful nontraditional venture capital funds are typically capitalized with a minimum of \$10 million.<sup>182</sup> This amount of capitalization allows funds to survive without a subsidy for operating expenses. It would also allow the fund to make deals in the \$1 million range, which should meet the needs identified in Kenworthy's survey.<sup>183</sup>

Because it is unlikely that any one investor, or type of investor, has the capacity to capitalize such a fund on its own, the new Alaska fund will need to attract several different investors. Perhaps the most obvious source of capitalization would be public funds provided by either the state or federal governments. Assuming that political will to make investments in a nontraditional venture capital fund exists, any new fund should first attempt to get

176. RUBIN, *supra* note 84, at 17.

177. *Id.* at 17-18.

178. *Id.* at 18.

179. MARKLEY ET AL, *supra* note 101, at 96 (describing an emerging fund in Ohio that has an alliance with a technical assistance provider that helps local businesses become "venture capital ready," refers businesses to the venture capital fund, and provides follow-up assistance after financing; this alliance is thought to help reduce investment risk and increase deal flow).

180. Kenworthy interview, *supra* note 156.

181. BARKLEY ET AL., *supra* note 107, at 9.

182. *Id.* at 16.

183. See Survey from Jamie Kenworthy, *supra* note 159.

some portion of its capital from the state.<sup>184</sup> While the individuals surveyed by Kenworthy are hesitant to approach the state for money to support a fund's economic development objectives,<sup>185</sup> the state is the most likely source of patient capital, meaning the investor is least likely to require an immediate return on investment. This is a significant advantage to using state revenue for a fund hoping to achieve any sort of double bottom line.

If the state does participate as an investor, it should not be expected to bear all of the risk while the other investors only reap the returns.<sup>186</sup> That is, the state should not participate in any type of CAPCO arrangement. Because of the possibility of political influence, however, the state should not be allowed to participate as a regular investor; rather, it should be expected to take some additional risk. For example, the state could partially protect the return of other investors by agreeing to take its portion of the return only after the other investors receive a minimum return. If the state would be unwilling to take on some additional risk, perhaps it could offer a one-time grant to help subsidize the fund's economic development goals. For example, North Dakota's governor has proposed three new venture capital funds; one is a \$10 million non-traditional fund used to finance new and existing businesses with \$3 million dedicated for technical assistance.<sup>187</sup>

In addition to state funds, the new fund may also want to obtain federal funding through the SBIC program. While there are no SBICs currently licensed in Alaska,<sup>188</sup> several individuals in Alaska

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184. Granted, these are big assumptions. Several factors suggest that the state would be unwilling to put forth any money for this project. First, Alaska previously invested several million in a venture capital fund that was unsuccessful and is no longer seeking deals within the state. While the state is supposed to get its investment back, it will receive no return and no other benefits. Second, the Permanent Fund—the most obvious place for the state to draw the money—is no longer earning as much money as it was when the broader economy was booming. See Kenworthy interview, *supra* note 156.

185. 2000 Letter, *supra* note 158.

186. Kenworthy interview, *supra* note 156. In fact, another possible source of capitalization should be the management of the fund itself. By putting some of their own capital in the fund, managers are more likely to keep the proper balance between risk and return when making investment decisions. This ensures that the public sector does not bear all of the risk.

187. National Association of Seed and Venture Funds, *North Dakota Governor Proposes State Venture Fund*, at <http://www.nasvf.org/web/allpress.nsf/pages5805> (Dec. 4, 2002).

188. Small Business Administration, at <http://www.sba.gov/gopher/Local-Information/Small-Business-Investment-Companies> (last visited Jan. 20, 2003).

would consider this option.<sup>189</sup> There is also at least one individual in Alaska who has previous experience operating an SBIC.<sup>190</sup> Because of the minimum private capitalization requirements, however, this cannot be the only source of funds. At least \$2.5 million in additional capitalization will need to be in place before the SBIC licensing process can begin. The capitalization for SBICs commonly comes from banks, but since there is only one state-based bank left in Alaska, it is less likely that banks will play this role. Therefore, other willing investors must be identified before this strategy is pursued.

An additional source of potential federal funds is the New Markets Tax Credit (“NMTC”) program. This program provides tax credits for investors who make equity investments in community development entities that, in turn, make loans to or investments in qualified low-income businesses.<sup>191</sup> As the first round of tax credit allocations was just made in the spring of 2003, it is too early to tell how effective this program will be in achieving its economic development goals. However, several of the entities that received allocations in the first round plan to participate in nontraditional venture capital investing. For example, Coastal Enterprises in Maine and the city of Phoenix in Arizona both plan to use the NMTC program to create new venture capital funds.<sup>192</sup> More importantly, Alaska Growth Capital in Anchorage received an allocation of \$5 million and may be authorized to use a portion of its allocation for equity investing.<sup>193</sup> Thus, this organization should be approached as either a potential partner for a new venture capital fund or as a source of capitalization if the goals of the new fund meet the guidelines of the NMTC program.

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189. Kenworthy interview, *supra* note 156.

190. Letter from Jamie Kenworthy, Executive Director, Alaska Science and Technology Foundation, to Board of Directors, Apr. 2001. This is important because meeting the SBA’s management requirements for SBICs can often be a bar to licensing.

191. I.R.C. § 45D; *see also* CDFI Fund, at <http://www.cdfifund.gov/programs/NMTC/index.asp>.

192. CDFI Fund, Allocation Profiles, at [http://www.cdfifund.gov/docs/2003\\_nmtc\\_allocation\\_profiles\\_alpha.pdf](http://www.cdfifund.gov/docs/2003_nmtc_allocation_profiles_alpha.pdf). The city of Phoenix has even found that several traditional venture capital funds have expressed interest in participating in their fund, even though the tax credit subsidy provided by the New Markets Tax Credit program is relatively shallow. The tax credit is viewed as an added enhancement to bring in additional investors and to make investments that might not have been previously considered. Telephone interview with Lynda Dodd, New Markets Tax Credit Coordinator, City of Phoenix (Oct. 27, 2003).

193. CDFI Fund, Allocation Profiles, *supra* note 190.

A final recommendation for capitalization would be to seek investment from the Alaska Regional Native Corporations.<sup>194</sup> The Regional Native Corporations (and their village corporation counterparts) were created by the Alaska Native Claims Settlement Act of 1971<sup>195</sup> through which Native Alaskans gained almost \$1 billion in cash and clear title to over forty million acres to settle all claims based on aboriginal land claims.<sup>196</sup> As a group, the Alaska Native Corporations are the state's largest private land owners, owning twelve percent of Alaska lands. The Corporations also own all or part of 125 businesses and employ over 10,000 people.<sup>197</sup> The financial performance of the various Regional Native Corporations has varied significantly from corporation to corporation, though on the whole, it has been very poor.<sup>198</sup> Since available capital is obviously not a concern for the corporations, it is becoming more apparent that a lack of good management has led to most poor performances.<sup>199</sup>

From the venture capital fund's perspective, having one or more of the Regional Native Corporations as an investor has significant advantages. The most obvious, of course, is the vast amount of capital that the corporations can bring to the table. An additional advantage of Native Corporation investors might be their ability to increase deal flow by recognizing opportunities within their corporations or regions, particularly in the more rural areas of the state. Several factors about this new venture capital firm may be attractive to the Regional Native Corporations as well. For example, there is evidence that many Regional Native Corporations perform better economically when partnered with external organizations.<sup>200</sup> If the new fund has good management and a mechanism for shared risk, this may appeal to the corporations. Second, if the new fund could provide an additional return to a Native Corporation that refers a deal—a finder's fee of sorts—this might provide an added incentive. Even without a finder's fee, the

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194. Kenworthy interview, *supra* note 156.

195. 43 U.S.C. § 1601-1629 (2003). The corporations are all organized as for-profit corporations (though the statute did allow for a non-profit model) with a goal of providing economic and social benefit to their Alaska Native shareholders. *Id.*

196. *Id.* § 1601(a); Steve Colt, *Alaska Natives and the "New Harpoon": Economic Performance of the ANCSA Regional Corporations 2* (Feb. 2001), at [http://hosting.uaa.alaska.edu/afsgc/colt\\_newharpoon2.pdf](http://hosting.uaa.alaska.edu/afsgc/colt_newharpoon2.pdf).

197. LEASK ET AL., *supra* note 2, at 8.

198. Colt, *supra* note 194, at 2-3.

199. *Id.* at 53.

200. *Id.* at 34.

prospects for helping create business that will in turn create more jobs for their shareholders may also appeal to the corporations.

#### D. Mechanics of the Fund: Location and Management.

In the past, there has been a preference for Alaska to house the branch offices of a fund based outside of the state instead of creating an Alaska-only risk capital institution.<sup>201</sup> Given the unique characteristics of potential deals within the state, however, creating a fund that is primarily based in Alaska would be a better strategy. Unless the outside fund is a nontraditional fund that is willing to make the kinds of deals that Alaska needs—ones with a lower potential rate of return, a greater need for technical assistance, and a likelihood for deals in slower growth industries—Alaska businesses are likely to get passed over for businesses located in other states. An Alaska-based fund that is able to attract an experienced management team and is willing to make some deals outside of the state will be better suited to meeting the state's needs.

As for management, a new Alaska fund should be managed by individuals who are experienced professional managers.<sup>202</sup> This means considering whether there are people already in Alaska who are qualified to manage a fund that has the dual objectives of economic development and achieving a decent return on investment. If there are not willing and qualified individuals within the state, people outside of Alaska will need to be identified. Ideally, managers from both inside and outside of Alaska should be hired to staff the fund. Because there are no nontraditional funds of this nature currently operating in Alaska, it may be difficult to find an in-state manager. Therefore, an outside manager is likely to bring additional investment skills that might be currently lacking within the state. An outside manager would also provide valuable connections to other funds that may be able to make co-investments in deals or provide follow-on financing.<sup>203</sup> Finally, the fund should look for managers committed to the same goals of balancing return on investment with economic development objectives.<sup>204</sup>

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201. See 2000 Letter, *supra* note 158.

202. Most nontraditional venture capital institutions have found that professional management was “critical to the success” of their funds. BARKLEY ET AL., *supra* note 109, at 11; see also *supra* notes 92-100 and accompanying text for a general critique of managing a fund with public employees.

203. 2000 Letter, *supra* note 158.

204. BARKLEY ET AL., *supra* note 109, at 8-9.

## V. CONCLUSION

As a strategy for supplementing Alaska's economic development policy, Alaska should support the development of a nontraditional venture capital organization. Nontraditional venture capital has proven to be a successful model for bringing risk capital to entrepreneurs in non-metropolitan areas outside of high tech corridors. Nontraditional venture capital also allows investors to achieve a double benefit: a return on investment coupled with economic development. Several individuals and organizations in Alaska have been laying the groundwork for a new fund for several years. Now is the time to put these plans in motion by building on the knowledge base within Alaska and the lessons learned from other states.

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