DESIGNING STARTUP CORPORATE LAW: A MINIMUM VIABLE PRODUCT

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Abstract

Startup companies and venture capital investments are flourishing worldwide, but at different rates in different countries. The myriad of corporate law reforms designed to change those patterns have had, generally, underwhelming results. A core reason behind the discrete impact of most reforms is that they focus on features of corporate law that are relevant, but that are no longer meaningful differentiators of legal systems' aptitudes to support the emergence and growth of innovative businesses. This paper argues that corporate law still matters, and that crucial—yet under scrutinized—legal rules could be leveraged to foster startups and venture capital finance. Specifically, the set of rules that govern boards, shares, and shareholders' agreements in non-listed corporations (collectively referred to as Startup Corporate Law or "SCL").

SCL determines the bargaining power between founders and investors over companies' cash-flow, control rights, and governance structure. The careful design of SCL could, thus, stimulate the growth of innovative firms by expanding founder-investor bargaining. Still, legal reforms to SCL are often introduced without meaningful deliberation. This creates enforcement and creditor protection challenges that remain underexplored, despite impacting businesses beyond startups. This paper discusses the most salient of those challenges and sketches a research agenda on SCL to assess the relationship between corporate law and venture finance more accurately.

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I. Introduction

Startup companies and venture capital investments are on a global surge. As a result, an unprecedented number of non-listed firms are seizing, disrupting, and even creating new markets. Many of these firms are consolidating massive customer bases and accumulating capital as only publicly traded companies were capable not too long ago.[1] Notwithstanding the increasing economic and social significance of these private firms, the laws that determine their governance and capital structures remain under scrutinized, particularly from a comparative perspective.[2] At the heart of this pending assignment is the assumption that corporate law is irrelevant for non-listed companies; an assumption that has been surprisingly resistant to fast-changing circumstances.

Legal scholarship typically characterizes private businesses as local organizations, owned and managed by a limited number of closely related participants (usually with family ties), and registered as partnerships or other inexpensive legal forms that are not generally governed by corporate law.[3] Even when these often-called small and medium enterprises (SMEs) register as corporations, their governance is assumed to be regulated by private agreements, rendering corporate law inconsequential to their governance and finance.[4]

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[1]Notable examples include *Go-Jek* in Indonesia, *Rappi* in Colombia and *OPay* in Nigeria. All of them have valuations over one billion dollars, interact with millions of customers in different countries and provide thousands of direct and indirect jobs. For an analysis, see *infra* Section II.

[2] Some exceptions are Ronald J. Gilson & David M. Schizer, *Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock*, 116 HARV. L. REV. 874–916 (2003) (examining the influence of tax law on venture capital structure), and Steven N. Kaplan, Frederic Martel & Per Strömberg, *How Do Legal Differences and Experience Affect Financial Contracts?*, 16 J. FIN. INTERMEDIATION 273–311 (2007) (analysing venture capital investments in non-US countries and US venture capital investments and discovering that legal regimes become insignificant).

[3] *See infra* Section III.B.

[4] *Id.*

The relevance of corporate law as a determinant of private firms' governance and finance has been further diminished by two recent regulatory trends. On the one hand, the proliferation of hybrid business forms, which generated an ongoing discussion among business law scholars on how the law—not only corporate law—could better support the needs of specific firms, such as professional services providers.[5] On the other hand, an outburst of reforms reducing registration requirements for businesses—not only corporations—has spawned a series of empirical studies discussing the impact of those requirements on entrepreneurship.[6]

By focusing on public corporations, the burgeoning scholarship in comparative corporate governance has also provided discrete insights on how corporate laws condition the governance and financial structures of non-listed firms.[7] And the literature on venture finance, which studies the funding of startup companies, has also minimized the relevance of corporate law for venture deals, which are considered to be in the domain of contracts.[8]

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[5] For an overview, see Joseph A. McCahery, THE GOVERNANCE OF CLOSE CORPORATIONS AND PARTNERSHIPS 1–19 (Joseph A. McCahery & Erik M. Vermeulen eds., 2004) ("His overview begins with the recognition that a single type of limited liability corporation cannot meet the specific demands that follow from business' commercial operation in different markets").

[6] *See*, *e.g.*, Leora Klapper et al., *Business Environment and Firm Entry: Evidence From International Data* (World Bank Pol'y Rsch. Working Paper No. 3232, 2004) (studying databases to determine how business environments and regulations improve or discourage the creation of new firms); and Simeon Djankov et al., *The Regulation of Entry*, Q. J. ECON. 31, 37 (2002) (presenting data regarding the impact of the number of procedures, costs, and time that companies have to complete in order to operate legally).

[7] Holger Fleischer, THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 679–720 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2016) ("It is only in recent times that researchers have begun to explore the corporate governance issues of closely held corporations more thoroughly. It is at this point that this chapter begins, by firstly identifying the fundamental governance problems in closely held corporations . . . and going on to explain their governance framework . . . .").

[8] Intriguingly, empirical studies that do explore the influence of laws and institutions in the financing of startup companies pervasively rely on indexes and rankings of legal systems that are either based on the regulation

Consequently, corporate law's influence on startups' governance arrangements and access to external finance remains underexamined. Such an examination is necessary for two reasons. First, virtually all fast-growing startups adopt the corporate form and, therefore, are subject to the corporate laws of the country in which they are incorporated.[9] Second, differences between legal systems matter for startups' main participants. There is evidence that investors and entrepreneurs experience difficulties in structuring trust-enhancing agreements in some jurisdictions, potentially discouraging deals and the expansion of the market for innovative firms.[10] Empirical evidence also shows that, when given the opportunity, entrepreneurs favor corporate laws perceived to offer higher flexibility, even when such decision deprives them of tax savings, an indication that overlooked differences in legal rules matter.[11]

The first step to identify such rules and their impact on startup finance is to acknowledge that, despite being governed by standard corporate law, startups are not ordinary firms.[12] They are uniquely engineered to quickly develop scalable businesses and capture, or even create new markets.[13] Meeting these ambitious objectives requires extraordinary amounts of capital that cannot be provided by traditional financiers, given uncertainties over

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of public corporations or use "legal origins" classifications that have been disproven by legal scholarship. *See infra* Section III.C.

[9] *See* Section IV.

[10] *See, e.g.*, Zenichi Shishido, *Does Law Matter to Financial Capitalism? The cases of Japanese Entrepreneurs*, 37 FORDHAM INT'L L.J. 1087, 1090 (2014) ("In Japan, venture capitalists are prevented from gaining control and entrepreneurs are not able to take advantage of sweat equity. Because of the two-sided agency problem both parties downsize new venture financing and are satisfied with smaller success.").

[11] *See infra* notes 88, 112 and accompanying text.

[12] Jared Hecht, *Are You Running a Startup or Small Business? What's the Difference?* FORBES (Dec. 8, 2017), forbes.com/sites/jaredhecht/2017/12/08/are-you-running-a-startup-or-small-business-whats-the-difference/?sh=5813f38b26c5 ("The intent of the startup founder is to disrupt the market with an impactful business model. They want to take over the market.").

[13] While the word "startup" is often used as a synonym of "new business," such practice overlooks the distinctive characteristics and needs of fast-growing companies with high-risks and high-returns, which are the focus of this paper. *See infra* Section II.

outcomes.[14] To finance the development of a concept into a business, its entry into the market and corresponding expansion, successful startups are financed by investors with superior industry knowledge and high-risk tolerance, who manage unknowns by sharing control over the company at different stages of its lifecycle.[15] In each stage, a potential financial deal is threatened by a deep mutual distrust: founders might lose their main assets (innovative ideas) if they reveal secrets or cede control over their development, and investors might lose their capital and their ability to pull funds and finance projects in the future.[16] The perfect deal, thus, is one that enhances trust, encouraging founders to develop the business and giving investors the confidence to provide additional capital or welcoming new investors to finance expansion.

The venture finance literature has identified the main risks that threaten successful deals between startup founders and investors but has mainly focused on contractual solutions.[17] An examination of the trade-offs that they must make reveals that corporate law plays a

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[14] For an overview of this issue, see Bronwyn H. Hall & Josh Lerner, *The Financing of R&D and Innovation*, *in* HANDBOOK OF THE ECONOMICS OF INNOVATION, ELSEVIER-NORTH HOLLAND 609 (Bronwyn H. Hall & Nathan Rosenberg eds., 2010) (discussing the issue of investment in knowledge and innovation and analyzing the potential policy options for innovation investment).

[15] *See* Jeffrey M. Pollack and Thomas H. Hawver, *Venture Capital*, *in* WORLD ENCYCLOPEDIA OF ENTREPRENEURSHIP, 642 (Léo-Paul Dana ed., 2d. ed. 2021) (reviewing the history of venture capital, how it compares to alternative funding options, and how entrepreneurs go about procuring funding via venture capital); *infra* analysis in Section IV.

[16] Unlike the principal-agent problem, which is one-sided, distrust between founders and investors is the result of a double-sided moral hazard. For an overview of this issue and its implications, see generally ROBERT COOTER, THE FALCON'S GYRE: LEGAL FOUNDATIONS OF ECONOMIC INNOVATION AND GROWTH (BERKELEY L. BOOKS ED. 2014) ("Economic innovation usually requires combining new ideas and capital. They naturally repel each other because the investor distrusts the innovator with her money, and the innovator distrusts the investor with his ideas.").

[17] *See, e.g.*, Josh Lerner & Ramana Nanda, *Venture Capital's Role in Financing Innovation: What We Know and How Much We Still Need to Learn*, 34 J. ECON. PERSPS. 237 (2020) (analyzing the growing issues in venture capital and proposing potential adaptations to respond to some of the issues identified).

crucial role in startup finance, framing the bargains between founders and investors, and ultimately the company's governance. By registering as corporations, startups not only access limited liability but also enable venture finance with various investors at different stages, as the corporate form is almost indistinguishable across jurisdictions and the only one capable of sustaining large-scale businesses.[18] From then on, financing agreements are contingent on corporate laws.[19] Convertible-debt, a common instrument in early-stage finance allowing startups to repay lenders with equity, relies on rules governing the issuances of shares.[20] Deferred equity purchases, a more flexible alternative, are equally dependent on these rules.[21] Investors that supply higher amounts of capital at later stages exercise control through customized shares and board structures,[22] as well as through shareholders' agreements, whose scope is determined by corporate laws.[23] Hence, subtle and under examined differences in corporate laws within and across jurisdictions could have a significant impact on startup founders' ability to reach trust-enhancing agreements with investors at different stages.

Based on these analyses, this paper defines "startup corporate law" (SCL) as the legal rules that delineate how cashflow and control rights are distributed in non-listed corporations in three categories: boards, shares, and shareholders' agreements. It submits that proper identification of differences in these rules is indispensable—yet absent—for sound comparative legal scholarship, accurate cross-border examination of venture deals, and public policy. For example, the extent to which startups' participants can regulate boards' powers (e.g., to issue new shares) directly impacts bargains over control, allowing investors to alleviate agency costs and moral hazard without purchasing a majority of the shares.[24] Differences in the rights that can be assigned to certain shares (e.g.,

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[18] *See infra* Section IV.A (analyzing the advantages of registering as a corporation, including the ways in which it enhances founder-investor trust).
[19] *See infra* Sections IV and V.
[20] *See infra* Section IV.B.
[21] *Id.*
[22] See Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281–315 (2003), and the discussion in Section IV.D.

[23] *See infra* Section V.D.
[24] *See infra* Section V.B..

liquidation preference) or included in shareholders' agreements (e.g., drag along), as well as the legal requirements to exercise those rights (e.g., legal standing), could also constrain or expand participants' ability to reach trust-enhancing deals.[25] Against the general understanding that non-listed firms are governed by enabling corporate laws and contracts, the analysis demonstrates that persistent variations in unobserved legal rules condition startups' governance and finance, and, ultimately, the development of startup ecosystems and venture capital markets. In doing so, it offers a renewed representation of corporate law that is essential for the comparative study of startups' governance and finance.

Acknowledging the overlooked evolution of SCL also enables the identification of new challenges and opportunities for corporate law design. Reforms reducing the costs of creating and operating a corporation might already be exposing creditors to opportunism, requiring an evaluation of personal and corporate bankruptcy standards, and a renewed approach to the circumstances leading to lifting or piercing the corporate veil.[26] A more flexible regulation of boards might also lead to situations in which some directors, elected with the votes of specific shareholders, might decide to act in the exclusive interest of their electors and not necessarily in the best interest of the company as a whole.[27] Whether those decisions fall under legal fiduciary duties (owed to all shareholders) or "privately developed duties" is also a contentious subject that influences bargains among founders and investors.[28] Enhanced freedom to issue classes of shares enables similar imbalances among shareholders' rights and potentially unfair outcomes, such as forced sales in which only one class participates in

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[25] *See infra* Section V.C.

[26] *See infra* Section V.A.

[27] *See infra* Section V.B. For a discussion of this issue in the United States, see Simone M. Sepe, *Intruders in the Boardroom: The Case of Constituency Directors*, 91 WASH. U. L. REV. 309–378 (2013) ("[B]ecause the majority of Trados directors 'had an ownership or employment relationship with an entity that owned Trados preferred stock,' they were to be held interested in the merger and therefore, subject to the strict entire fairness test, rather than the much more flexible business judgment rule.").

[28] *See generally* Robert Bartlett & Eric Talley, *Law and Corporate Governance*, 1 *in* THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE 177–234 (Benjamin E. Hermalin & Michael S. Weisbach eds., 2017), and the discussion in Section V.B.

the gains.[29] There is evidence that startup finance participants seek to strengthen governance arrangements or circumvent legal restrictions through shareholders' agreements, increasing the relevance of shedding light in an otherwise obscure area of corporate law; particularly, the extent to which they can be used to waive fiduciary duties, and whether they might be arbitrable.[30]

SCL is, thus, essential for the effective design and evaluation or corporate law incentives to startup finance. Borrowing startup jargon, the analyses and framework proposed in this paper are a *minimal viable product*, one with "just enough features" enabling researchers to evaluate, on the one hand, how corporate laws determine the range and characteristics of venture finance deals across-jurisdictions, and, on the other hand, the enforcement challenges generated by under scrutinized reforms.[31]

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[29] *Id.*

[30] *See* Jill E. Fisch, *Stealth Governance: Shareholder Agreements and Private Ordering*, 99 WASH. U. L.REV. 913, 930–31 (2021) (finding that shareholder agreements are used to "allocate rights of shareholders"; shareholder agreement may specify arbitration for dispute and waiver of litigation alleging breach of fiduciary duty); Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 YALE J. ON REG. 1124 (2021) (analyzing the use of shareholder agreements to allocate control rights contractually, based on hand-collected evidence from VC-backed companies in the United States); CAMILLE MADELON & STEEN THOMSEN, CONTRACTING AROUND OWNERSHIP: SHAREHOLDER AGREEMENTS IN FRANCE 253, 269–71 (Per-Olof Bjuggren & Dennis C. Mueller eds., 2009) (finding that "The benefit of shareholder contracts will be particularly high (and exceed the costs) when no other mechanism effectively addresses the issues" including equity rights); Rainer Kulms, *A Shareholder's Freedom of Contract in Close Corporations—Shareholder Agreements in the USA and Germany*, 2 EUR. BUS. ORG. L. REV. 685 (2001) (observing that a "minority shareholder could invoke the terms of a majority control agreement" to prevent majority shareholders frustrate investment interest of minority shareholders).

[31] The term "minimum viable product" was "coined by Frank Robinson and popularized by Eric Ries, founder of the Lean Startup methodology. According to Ries, an MVP is the version of a new product that allows the team to gather the maximum amount of proven customer knowledge with the least amount of effort." Maksym Babych, *A Review of the Minimum Viable Product Approach*, FORBES, forbes.com/sites/theyec/2021/12/08/a-review-of-the-minimum-viable-product-approach/ (last visited Feb. 19, 2022).

The paper is divided into seven sections. Section II outlines the distinctive features that make startups unfit for the SMEs framework, prevalent in the comparative study of non-listed firms. Section III discusses the relevance of the corporation and corporate law for startup companies and why it has been insufficiently scrutinized. Section IV reviews corporate law through the lens of startup founders and investors, identifying the legal institutions that enable and define the finance and governance of startups at different stages. Section V introduces "startup corporate law," detailing how the regulation of boards, shares, and shareholders' agreements of non-listed corporations condition startups' access to external finance, identifying emerging challenges and opportunities for future research. Section VI outlines the main implications of the analyses and proposed framework for comparative corporate law studies, cross-border examination of venture deals, and public policy. Section VII presents the conclusions.

II. The Expanding Significance of Startup Companies

Startups are often defined as "large companies in an early stage." Indeed, their ambitious business models, financial needs, and governance structures make startups a special type of non-listed firms.[32] Unlike traditional SMEs, startups are modeled to introduce new products or services and rapidly scale-up beyond their place of foundation.[33] Since their extraordinary capital needs and high-risks make founders' pay-in capital and debt either insufficient or unavailable, startups are financed by repetitively and strategically issuing and selling shares to venture capital firms or funds.[34] These

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[32] Fisch, *supra* note 31, at 928 ("VC-funded startups differ substantially from the prototypical close corporation. They have centralized management, hundreds of shareholders--many of whom are passive investors--and shares that are frequently traded, albeit not in the public markets.").
[33] Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 159 (2019) ("With their focus on technology and innovation, and their correspondingly high levels of risk and emphasis on growth, startups are different from both public corporations and traditional closely held corporations").
[34] *See generally*, Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461 (1995).

investment vehicles are created by industry experts, who act as intermediaries of less-exposed investors, selecting promising businesses to finance and then monitoring the investments to ensure that at least one of them can produce enough returns for the entire portfolio, ideally by selling their stock in an initial public offering (IPO).[35] Consequently, startup governance is uniquely complex, shaped by the interests and bargains of founders, an increasing number of active investors, and key employees, who are occasionally incentivized with the right to receive shares once certain milestones are met.[36] These business, finance, and governance idiosyncrasies, hidden by the frequent interchangeable use of "startup," "new business," and SMEs among policymakers, are crucial to understanding startups' expanding significance around the world and the renewed relevance of corporate law for non-listed firms.

From a business perspective, startup companies have led the development of innovative products and services in the new millennium, capturing significant segments of relevant markets and even creating new ones worldwide.[37] The so-called "unicorns"—i.e.,

[35] *See generally*, PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE (2d. ed. 2004) (providing an overview of venture capital industry through analysis on research findings in venture cycle); JOSEPH W. BARTLETT, FUNDAMENTALS OF VENTURE CAPITAL (1999) (analyzing the fundamental issues facing venture capitals for both investors and entrepreneurs); William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON. 473, 473–521 (1990) (discussing the structure of venture capital and how they raise money from individuals and institutions for investment in startups business).

[36] Sahlman, *supra* note 37, at 473–521 ("Venture capitalists attack [governance] problems in several ways. First, they structure their investments so they can keep firm control. The most important mechanism for controlling the venture is staging the infusion of capital. Second, they devise compensation schemes that provide venture managers with appropriate incentives. Third, they become actively involved in managing the companies they fund, in effect functioning as consultants. Finally, venture capitalists preserve mechanisms to make their investments liquid.") *See also* Hellmann & Puri, *supra* note 33 at 169–97 ("Obtaining venture capital is related to a variety of organizational milestones, such as the formulation of human resource policies, the adoption of stock option plans, or the hiring of a VP of sales and marketing. . . . The effect of venture capital is also particularly pronounced in the early stages of a company's development.").
[37] *Id.*

companies with a private valuation of over a billion dollars—are the quintessential representation of this global trend.[38] For example, before going public, *Airbnb* and *Uber* attracted much of the public's attention, due to their millions of users and clients around the world, and for innovative business models that encourage regulatory changes.[39] These and other U.S. unicorns, however, are just the tip of a startup iceberg. Indonesian *Go-Jek*, for instance, which offers transportation, payment, and delivery services to hundreds of millions of customers, reached a 10 billion dollar valuation in less than ten years, partnering with over "2 million driver[s] . . . and 400,000 merchants. . . ."[40] In Colombia, *Rappi* transformed a poorly developed food delivery market and managed to raise 1 billion dollars in 2019, which allowed *Rappi* to strengthen its expansion to

[38] The term "unicorn" was coined by venture capitalist Aileen Lee in 2013, to highlight how unusual it was for private companies to reach such valuations at that time. Lee merely considered US software companies and found only thirty-nine unicorn companies. The latest global account, which includes companies in all industries, identified over 400 unicorn companies, many in emerging markets, such as China, India, and Brazil. *See* Aileen Lee, *Welcome to the Unicorn Club: Learning from Billion-Dollar Startups*, TECHCRUNCH (Nov. 2, 2013, 2:00 PM), techcrunch.com/2013/11/02/welcome-to-the-unicorn-club/ [perma.cc/V7AD-93UE]; *The Global Unicorn Club*, CB INSIGHTS, cbinsights.com/research-unicorn-companies [perma.cc/D9BQ-BB8W].

[39] These and other companies for which "changing the law is a significant part of [their] business plan," tend to mobilize users and other stakeholders. Jordan Barry and Elizabeth Pollman defined this practice as "regulatory entrepreneurship." *See* Elizbeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383, 383 (2016).

[40] *See* Manish Singh, *Gojek Founder and CEO Nadiem Makarim Resigns to Join Indonesian Cabinet; Soelistyo and Aluwi to be New Co-CEOs*, TECHCRUNCH (Oct. 21, 2019), techcrunch.com/2019/10/20/gojek-founder-and-ceo-nadiem-makarim-resigns-to-join-indonesian-cabinet-soelistyo-and-aluwi-to-be-new-co-ceos/ [perma.cc/4YM2-AT2X] (explaining that *Go-Jek* "has since expanded to include a range of services, including mobile payments, food delivery, online shopping and, most recently, on-demand video streaming. The startup has amassed more than 2 million driver partners and 400,000 merchants on its platform. Gojek was valued at almost $10 billion in its most recent financing round."). For updated valuation information, *see The Global Unicorn Club*, *supra* note 40.

greater Latin America.[41] In Nigeria, *OPay* and *PalmPay*, two *fintech*[42] startups founded in 2019, raised over 200 million dollars in just a few months.[43]

Although this phenomenon is largely linked to technological advancements and changes in consumers' preferences, startup companies have also benefited from—and contributed to—an ongoing expansion of the financial resources available for them.[44] Venture Capital (VC), broadly understood as equity investments in "early-stage businesses that offer high potential but high risk," is no longer restricted to Californian tech companies but available for businesses around the world.[45] In fact, the *2021 National Venture Capital Association Yearbook* reported a continuous increase in global venture investments, with the share going to U.S. companies declining from eighty-three percent in 2004 to fifty-one percent in 2020.[46] The rise of global VC investments is crucial for the

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[41] Mary Ann Azevedo & Natasha Mascarenhas, *Colombian On-Demand Delivery Unicorn Rappi Raises $1B From SoftBank*, CRUNCHBASE NEWS (Apr. 30, 2019), news.crunchbase.com/venture/colombian-unicorn-rappi-reportedly-raising-1b-from-softbank/ [perma.cc/FF5G-ZU4G] ("SoftBank Group and the Vision Fund will each invest up to $500 million in Bogota-based Rappi, according to a release by the company. The investment also marks the largest technology financing to date in a Latin America-based company . . . .").

[42] "Fintech" refers to a "wide universe of innovative technology-enabled financial services." *See* Saule T. Omarova, *New Tech v. New Deal: Fintech as a Systemic Phenomenon*, 36 YALE J. ON REG. 735, 736 (2019).

[43] Jake Bright, *Lessons from M-Pesa for Africa's new VC-Rich Fintech Startups*, TECHCRUNCH (Dec. 4, 2019, 7:42 AM) techcrunch.com/2019/12/04/lessons-from-m-pesa-for-africas-new-vc-rich-fintech-startups/ [perma.cc/W67P-VBLW] (last visited Feb 19, 2022) ("Chinese investors put $220 million into OPay and PalmPay—two fledgling startups with plans to scale in Nigeria and the broader continent[.]").

[44] *See* Sahlman, *supra* note 37 at 473–521 (1990).

[45] *See* Joshua Aizenman & Jake Kendall, *The Internationalization of Venture Capital*, 39 J. ECON. STUD. 488–511 (2012) (providing evidence of the accelerated pace of internationalization since the 1990s).

[46] 2021 NAT'L VENTURE CAP. ASS'N Yearbook, NAT'L VENTURE CAP. ASS'N. 1, 5–23 (2021), nvca.org/research/nvca-yearbook/ ("In 2020, the US remained the destination for about half of global VC investment dollars, attracting 51% of global capital invested. This year's share of global investment is up slightly from the 49% reported for 2019 and is eight percentage points

development of innovative businesses, as these active investors not only provide capital, but also various value-adding services, such as board professionalization and access to business and financial networks.[47] Naturally, governments are taking note. Reforms facilitating (or even promoting) investments in private companies through VC are on the rise.[48] Angel investors, which are usually wealthy individuals with startup experience, complement VCs, by financing the development of a product or a business model, even before they are tested in the market.[49]

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higher than the most recent low of 43% in 2018. However, these percentages stand in stark contrast to the 83% global share the US garnered in 2004, when the US held dominant sway over investors, and serves as a good reminder that capital and talent are everywhere.").

[47] Hellmann and Puri, *supra* note 33, at 194 (concluding, from an analysis of hand-collected data from surveys, interviews and commercial databases, that "venture capital is related to a variety of organizational milestones, such as the formulation of human resource policies, the adoption of stock option plans, or the hiring of a VP of sales and marketing."); *see generally* GOMPERS & LERNER, *supra* note 37 (explaining that a common misconception "is that venture capitalists are purely passive financiers of entrepreneurial firms who are unlikely to add much value.").

[48] An example is Chilean Law 20.190 (2007), which introduced a simplified corporate form and tax benefits for investments in VC funds. Law No. 20.190, May 17, 2007, DIARIO OFICIAL [D.O.] (Chile). For analysis on its impact in firm formation, see Alvaro Pereira, *Simplified Corporations and Entrepreneurship*, 21 J. CORP. L. STUD. 433, 433–65 (2021). Support for lifting the "Volcker" restrictions on banks' investments in VC funds also signals interest in canalizing resources to startups through VC in the U.S. *See* Andrew Ackerman, *Banks Face Eased Volcker Restrictions on Venture-Capital Funds*, WALL ST. J. (Jan. 27, 2020) wsj.com/articles/banks-face-eased-volcker-restrictions-on-venture-capital-funds-11580172708.

[49] *See* Judith J Madill et al., *The Role of Angels in Technology SMEs: A Link to Venture Capital*, 7 VENTURE CAPITAL 107, 107–129 (2005) (finding, from a sample of 766 technology firms in Canada, that 57% of those that had received private investor financing had also received financing from institutional venture capitalists; only 10% of firms that had not received angel financing obtained venture capital); *See also* John Berns & Karen Schnatterly, *Angel Investors: Early Firm Owners*, *in* SHAREHOLDER EMPOWERMENT: A NEW ERA IN CORPORATE GOVERNANCE 223, 223–238 (Maria Goranova & Lori Verstegen Ryan eds., 2015) ("Recently, formalized groups of angel investors have become more prevalent.").

The contraction of stock markets[50] and the decline in IPOs in the United States[51]—a symptom of global changes in capital markets[52]—have also granted startup companies access to funds from

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[50] *See* René M. Stulz, *The Shrinking Universe of Public Firms: Facts, Causes, and Consequences*, 2 NBER REP. 1, 1–13 (2018), data.nber.org/reporter/2018number2/stulz.html (detailing the causes for a sharp decline in the number of listed firms around the world, particularly in the United States, which "went from 23 listed firms per million inhabitants to 11" between 1976 and 2016); *see also* Craig Doidge, Kathleen M. Kahle, George Andrew Karolyi, & René M. Stulz, *Eclipse of the Public Corporation or Eclipse of the Public Markets?*, 30 J. APPLIED CORP. FIN. 8, 8 (2018) ("We next show that in the U.S. small firms have left the exchanges and that the propensity of these small firms to list has fallen sharply since 1997.").

[51] After its peak in 1997, US IPOs have decreased dramatically, due inter alia to the cost of listing and compliance obligations, as well as to the globalization of finance. *See* Paul Rose & Steven Davidoff Solomon, *Where Have All the IPOs Gone: The Hard Life of the Small IPO*, 6 HARV. BUS. L. REV. 83, 87 (2016) (finding that only large businesses are capable of surviving the compliance costs and market pressures faced by public corporations in the U.S.); s*ee also* Les Brorsen, *Looking Behind the Declining Number of Public Companies*, HARV. F. ON CORP. GOV. 1, 12 (May 18, 2017) corpgov.law.harvard.edu/2017/05/18/looking-behind-the-declining-number-of-public-companies/ ("The dynamics in the private capital market have changed significantly, at least temporarily, and allow companies to grow larger and stay private longer. The amount of private investment has grown immensely and takes many forms, including venture capital, private equity and debt financing. Companies that make it to a public offering in recent years have tended to be more mature and have solid business prospects . . . .").

[52] *See* Craig Doidge, George Andrew Karolyi, & René M. Stulz, *The U.S. Left Behind? Financial Globalization and the Rise of IPOs Outside the U.S.*, 10 J. FIN. ECON. 546, 546 (2013) (finding that "[f]inancial globalization reduces the impact of national institutions on domestic IPO activity . . . [enabling] more non-U.S. firms from countries with weak institutions to go public with a global IPO."); Kathleen Kahle & René M Stulz, *Is the U.S. Public Corporation in Trouble?*, at 1 (Nat'l Bureau of Econ. Rsch. Working Paper No. 22857, 2016) (considering that the internet has reduced the costs associated with searching and contacting investors and founders, which used to be a crucial advantage of stock exchanges); *see generally* Alex Katsomitros, *The Slow Death of Global Stock Markets*, WORLD FIN. (Apr. 15, 2019) worldfinance.com/markets/the-slow-death-of-global-stock-markets ("Over

sources previously reserved to public corporations. Institutional investors and even banks are investing in VCs and creating special funds for startups, a practice inconceivable not too long ago.[53] Whether through the acquisition of ventured-backed companies or by participating in startup funds, private equity (PE) firms are also offering an exit to early investors and founders of fast-growing companies,[54] contributing to their proliferation and success.[55]

Governments and intergovernmental institutions, in turn, are establishing funds with the specific purpose of investing in these firms.[56] A notable example is *Yozma Ltd*, which successfully

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the past two decades, the number of listed companies has dropped on both sides of the Atlantic.").

[53] *See* Jeff Schwartz, *Should Mutual Funds Invest in Startups: A Case Study of Fidelity Magellan Fund's Investments in Unicorns (and Other Startups) and the Regulatory Implications*, 95 N.C. L. REV. 1341, 1341 (2016) ("Contrary to longstanding practice and to their reputation for investing in public companies, mutual funds, including some of the most prominent, are allocating portions of their portfolios to private venture-stage firms, including famous unicorns like Airbnb and Uber."); *see also* Sergey Chernenko, Josh Lerner & Zeng Yao, *Mutual Funds as Venture Capitalists? Evidence from Unicorns*, at 1–4 (Nat'l Bureau of Econ. Rsch., Working Paper No. 23981, 2017).

[54] *See generally* Michael Ewens & Joan Farre-Mensa, *The Deregulation of the Private Equity Markets and the Decline in IPOs* (Nat'l Bureau of Econ. Rsch., Working Paper No. 26317, 2019) (providing evidence that private investors have financed the growth of the largest startups, which previously was only possible through an IPO).

[55] Private equity has proven to improve firm performance. *See*, *e.g.*, Douglas J. Cumming, Mike Wright & Donald S. Siegel, *PE, Leveraged Buyouts and Governance,* 13 J. CORP. FIN. 439, 440 (2007) ("[O]n average, pre-transaction shareholders reap a premium of approximately 40% when the transaction is consummated."); Steven N. Kaplan & Per Stromberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSPECTIVES 121, 130 (2009) ("[P]rivate equity firms apply financial, governance, and operational engineering to their portfolio companies, and, in so doing, improve firm operations and create economic value.").

[56] Recent empirical evidence indicates that government funds increase overall finance to non-listed companies. *See* James A. Brander, Qianqian Du & Thomas Hellmann, *The Effects of Government-Sponsored Venture Capital: International Evidence*, 19 REV. FIN. 571, 571 (2015) (finding, from a sample of 20,446 companies—in 25 countries—receiving equity investments in an eight-year period, that "markets with more [Government Sponsored Venture Capital (GVC)] funding have more VC funding per

triggered the VC ecosystem in Israel,[57] managing more than 200 million dollars and financing over 50 companies since its creation in 1993.[58] In China, the government-backed *Shenzhen Capital Group* has invested in more than 900 companies in multiple countries, from which 145 have been "listed in 16 different capital markets worldwide," since its creation in 1999.[59] More recently, intergovernmental efforts such as the European *VentureEU*[60] and the Latin American *Pacific Alliance Venture Capital Fund*[61] are offering further financing alternatives for private companies in those regions.

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enterprise and more VC-funded enterprises, suggesting that GVC finance largely augments rather than displaces [private venture capital] finance.").

57 *See* Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1098 (2002) ("The Yozma funds ultimately increased in size to over $200 million and in 1997 were successfully privatized."); Gil Avnimelech & Morris Teubal, *Targeting Venture Capital: Lessons from Israel's Yozma Program*, FIN. SYS., CORP. INV. INNOVATION, AND VENTURE CAP. 85, 89 (Anthony Bartzokas & Sunil Mani eds., 2004) ("The pre-emergence conditions specified above enabled an appropriate design of a targeted VC policy program (Yozma) which stimulated VC entry of professional VC companies and 'collective' learning.").

58 YOZMA, *Overview*, yozma.com/overview/default.asp (presenting Yozma's investment strategy and results, including 39 global IPOs and 24 technology incubators led).

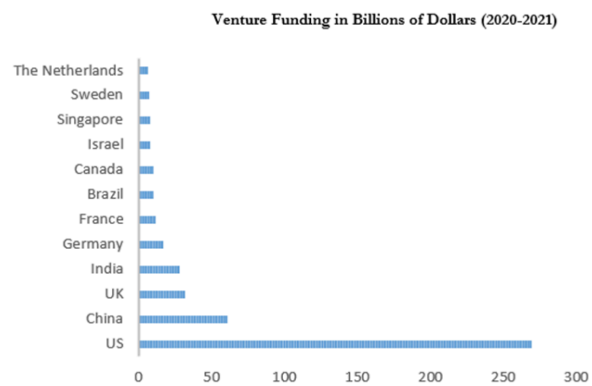
59 CRUNCHBASE, *Shenzhen Capital Group*, crunchbase.com/organization/shenzhen-capital-group#section-overview.

60 EUROPEAN COMM'N, *VentureEU: €2.1 Billion to Boost venture Capital Investment in Europe's Innovative Start-up*, at 1 (Apr. 10, 2018), ec.europa.eu/commission/presscorner/detail/en/ip_18_2763 ("The European Commission and the European Investment Fund (EIF) have launched a Pan-European Venture Capital Funds-of-Funds programme (VentureEU) to boost investment in innovative start-up and scale-up companies across Europe.").

61 *IDB Supports Creation of Pacific Alliance Venture Capital Fund*, INT'L DEV. BANK (Apr. 6, 2016), iadb.org/en/news/idb-supports-creation-pacific-alliance-venture-capital-fund ("The Pacific Alliance is a regional integration initiative made up of Chile, Colombia, Mexico and Peru. The Fund, to be capitalized with up to $100 million, is intended to facilitate financing and investment for small and medium-sized enterprises . . . .").

Figure 1: Largest Global Markets for Venture Funding[62]

Starting a Business 2020	Protecting Investors 2020
24	79
38	28
4	3
27	18
3	7
138	61
36	45
125	61
136	13
18	7
45	28
55	36



While markets have gradually adjusted to the expanding significance of this special type of non-listed firm, the study of corporate law and its influence on their governance and financial structure has stagnated.[63] Over the past three decades, most efforts have centered on reducing business registration requirements and strengthening investor protection in public markets, leading to a quasi-homogeneous regulatory environment in those areas.[64] Yet, as illustrated by Figures 1 and 2, startup finance flows continue to diverge significantly across countries, often inconsistently with

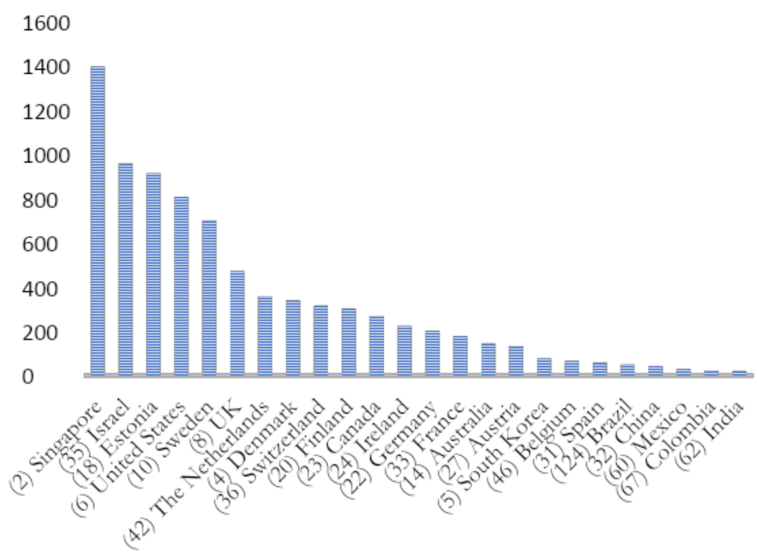
[62] *See* Joanna Glasner, *These Countries Have The Most Startup Investment For Their Size*, CRUNCHBASE NEWS (2021), news.crunchbase.com/news/countries-most-startup-investment/; World Bank, *Alternative Existing Indicators*, WORLD BANK, at 1 tbl.1 (see embedded link) (2021), worldbank.org/en/programs/business-enabling-environment/alternative-existing-indicators.

[63] For an analysis of how the expanding significance of non-listed firms challenges traditional theories and debates in corporate law and governance, see Bartlett and Talley, *supra* note 29.

[64] Pereira, *supra* note 50, at 434 ("Unlike the regulation of entry, which unleashed an expanding volume of empirical studies measuring the impact of changes in registration requirements, the comparative analysis of substantive company law incentives to entrepreneurship has been narrower and mostly theoretical.").

dominant rankings of the quality of corporate law. To assess the relevance of corporate law for startups, then, it is necessary to look beyond those traditional measures. The next session discusses the main reasons why the legal and financial scholarship have neglected such an urgent task, and why a renewed comparative approach to the corporate form and corporate law is essential for the study of startup finance and governance.

Figure 2: Venture Funding Per Capita by Selected Nations with Over $1 Billion in Startup Investment[65]



NOTE: Venture Funding Per Capita in Billions of Dollars, October 2020-2021. In brackets, World Bank's Ease of Doing Business 2020.

III. Corporate Law and Startups: An Overlooked Link

A. The Corporation and Corporate Law

[65] Glasner, *supra* note 64 (displaying venture funding per capita in billions of dollars across a selected countries); WORLD BANK, *supra* note 64.

The corporation (or joint-stock limited liability company) is the most common legal form for business organization, recognized in virtually all market economies, due to essential features that have proven to enhance the finance and growth capabilities of large-scale and long-term business ventures—startups' target.[66] Limited liability protects members' assets from the firm's creditors, promoting riskier business endeavors and efficient management.[67] Legal personality—i.e., the legal recognition of its own rights and obligations—reduces transaction costs,[68] and shields corporate assets from members' creditors, ensuring continuity in time regardless of changes in share ownership.[69] Asset partitioning and entity shielding, two proprietary features exclusive of the corporate form that are

[66] *See* FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 40–41 (1996) (describing how the limited liability of corporations lessens costs "when the technology of production requires firms to combine both the specialized skills of multiple agents and large amounts of capital").

[67] Management efficiency results from the fact that the firm's value is determined by their performance, and not by the owners' assets. *See id.* at 42–43.

[68] Notably, the cost of engaging and amending contracts. *See* MICHAEL JENSEN, A THEORY OF THE FIRM: GOVERNANCE, RESIDUAL CLAIMS AND ORGANIZATIONAL FORMS 36 (Harv. Univ. Press, 2000) (observing that contracts granting limited liability to shareholders results in lower transaction costs compared to an unlimited liability contract on aggregate).

[69] Legal personality shields corporate assets from owners and owners' creditors and vice versa, by 'locking in' the capital—participants can trade their rights but not their capital—a feature not offered by other business forms. *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 387–456 (2003) ("The ability to commit capital generally helped promote and protect the interests of shareholders as a group by making it possible for the entity to invest in long-term, highly specific investments. It also helped protect a wide range of enterprise participants who made specialized investments in reliance on the continued existence and financial viability of the corporation.").

non-replicable by contract,[70] reduce the cost of credit, as the business' valuation is independent of shareholders' personal assets.[71]

Corporations are also required to have a board of directors, responsible for the business strategy and the election and monitoring of executive officers, among others,[72] and are ultimately controlled by investors, the capital providers, who have the right to corporate net earnings.[73] Crucially, corporate capital is divided into marketable shares of future earnings, not only ensuring that their owners can exit without dissolving the business while also offering the ability to

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[70] Hansmann and Kraakman introduced the concept of "affirmative asset partitioning" to note that, by law, corporate owners' personal creditors cannot execute against corporate interests. Building upon it, Armour and Whincop demonstrated that property law also assists corporate law in more general aspects that minimize "the costs imposed on third parties by this protection." To the extent that these property foundations are legal, they cannot be replicated by contract. *See, respectively*, Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387, 387–440 (2000); John Armour & Michael J. Whincop, *The Proprietary Foundations of Corporate Law*, 27 OXFORD J. L. STUD. 429, 429–465 (2007).

[71] Corporate creditors are not only protected from the personal creditors of the corporations' owners but also from opportunistic attempts of one owner against the others, which can affect the continuity or stability of the business—e.g., granting entitlements to third parties. *See* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 9 (3rd ed. 2017) ("[T]hese forms of asset shielding (or "asset partitioning") ensure that business assets are pledged as security to business creditors, while the personal assets of the business's owners are reserved for the owners' personal creditors.").

[72] *See generally id.* at 1–28.

[73] *Id.* (differentiating aspects of partnerships and partnership-type entities, where ownership is assigned to contributors of labor, as well as cooperatives, in which economic and controlling rights are assigned in proportion of acts of patronage); *see also* Hansmann and Kraakman, *supra* note 72 (discussing how corporations must have a "designated pool of assets that are available to satisfy claims by the firm's creditors," which usually take the form of investors and capital providers).

capitalize the firm through the issuance and selling of these shares—that is, without recurring to debt.[74]

Due to these characteristics, which gave a competitive advantage to the first corporations in the 17th century,[75] the corporate form became the dominant business entity in contemporary market economies after the industrial revolution.[76]

Most jurisdictions distinguish corporations into "non-listed" and "listed."[77] By default, a legal entity with the aforementioned characteristics is a non-listed corporation, governed almost

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[74] *See generally* Charles K. Whitehead, *The Evolution of Debt: Covenants, the Credit Market, and Corporate Governance*, 34 J. CORP. L. 641, 641–78 (2008) (describing how owners of corporate capital have "the ability to transfer or diversify away credit risk"). An influential account of the distinctive factors between debt and equity finance is in Oliver E. Williamson, *Corporate Finance and Corporate Governance*, 43 J. FIN. 567, 581 (1988) ("Debt is a governance structure that works out of rules and is well-suited to projects where the assets are highly redepoloyable. Equity is a governance structure that allows discretion and is used for projects where assets are less deployable.").

[75] Giuseppe Dari-Mattiacci et al., *The Emergence of the Corporate Form*, 33 J.L. ECON. & ORG. 193, 193–236 (2017). ("[D]uring the 17th century, the business corporation gradually emerged in response to the need to lock in long-term capital to profit from trade opportunities with Asia.").

[76] *See* Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1335, 1335–1403 (2006) ("Economic activity in modern societies is dominated not by individuals, but by firms that own assets, enter contracts, and incur liabilities that are legally separate from those of their owners and managers."); Katharina Pistor et al., *Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 791–872 (2002) ("The corporate form is regarded as another milestone for industrialization, the creation of viable market economies, and ultimately economic prosperity."); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 387–456 (2003) ("The ability to commit capital generally helped promote and protect the interests of shareholders as a group by making it possible for the entity to invest in long-term, highly specific investments.").

[77] *See* Alex Katsomitros, *The Slow Death of Global Stock Markets*, WORLD FIN. (Apr. 15, 2019) worldfinance.com/markets/the-slow-death-of-global-stock-markets (last visited Feb. 19, 2022) (discussing private vs. public, or listed, companies in various jurisdictions).

exclusively by corporate law.[78] A corporation turns to listed status "by making a public offering of securities, listing securities on a national securities exchange, or by reaching a certain asset size and number of shareholders of record," in which case it is also governed by securities regulations.[79] Naturally, most corporations are non-listed; and a swelling number of listed corporations are de-listing,[80] further increasing the relevance of the legal rules that govern these firms.

B. The Apparent Irrelevance of Corporate Law for Non-listed Firms

Notwithstanding the above, the relevance of the corporate form (and corporate law) for non-listed firms has been consistently questioned or ignored, which explains its dissociation with startup companies.[81] One traditional account is that, because most non-listed firms have a reduced number of closely related participants, the corporation provides no real advantage over less expensive forms, such as partnerships.[82] It is also submitted that, even when private

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[78] At this stage, that corporate law has proprietary foundations and, in that sense, it is not a completely isolated legal regime. *See* Hansmann & Kraakman, *supra* note 72, at 387–440 (2000).

[79] Pollman, *Startup Governance*, *supra* note 35. The requirements are similar but not identical across jurisdictions. For example, according to Chilean law, corporations become public when they have 500 or more shareholders, or when 100 shareholders own 10% or more of the standing shares. In Peru, the threshold is 1,000 or more shareholders holding at least 25% of the outstanding shares. *See, respectively,* Ley No. 18.046 (1981), *Sobre Sociedades Anonimas*, Article 2; Decreto Legislativo 672 (Sept. 1991) Article 15.

[80] *See* Alex Katsomitros, *The Slow Death of Global Stock Markets*, WORLD FIN. (Apr. 15, 2019) worldfinance.com/markets/the-slow-death-of-global-stock-markets (last visited Feb. 19, 2022) (offering evidence that that strict regulation and volatility of stock markets, listing costs, and "the explosion of mergers and acquisitions, driven by increasing private equity buyouts," are behind this global delisting trend).

[81] *See* Pereira, *supra* note 50 at 433–65 (remarking on how academic and policy discussions of corporate law are distanced from the role of corporate law in the governance of non-listed companies).

[82] *See* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 271–301 (1985) ("Partnerships can

businesses adopt the corporate form, participants implement equal sharing and management constraining rules to reduce the risk of opportunism by controlling shareholders and, because those types of arrangements are better addressed by partnership law, it is the law of partnerships and not corporate law which matters for the governance of non-listed firms.[83]

While partnerships are no longer considered the optimal form for expanding businesses in the twenty-first century, the relevance of the corporation and corporate law is also overlooked by comparative studies of non-listed firms, which have focused on two contemporary developments. On the one hand, the emergence new legal entities with elements from partnerships and corporations designed to accommodate the needs of heterogeneous groups of businesses and investors, such as professional services providers and even VC funds.[84] On the other hand, the so-called "regulation of entry", which posits that registration requirements condition the rate of newly registered businesses and should thus be reduced.[85] Over the past two decades, a rich series of quantitative studies has explored

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arise by operation of law without any express agreement between the parties; closely held corporations exist only as a result of formal documents and (typically) the assistance of an attorney."); Timothy Guinnane et al., *Putting the Corporation in its Place*, 8 ENTER. & SOC. 687, 687–729 (2007) (finding that, in jurisdictions where the law provided some minimal protection against ultimate dissolution of partnerships, such as in the early 1900s France and Germany, private businesses would overwhelmingly choose it over the corporation, without significantly risking their access to external finance. This line of research suggests that widespread dominance of the corporation among business organizational forms is a result of lack of alternatives—mainly in the United States—rather than an inherent superiority).

[83] Easterbrook and Fischel, *supra* note 84, at 297 ("Equal sharing rules, automatic buyout rights, and strict fiduciary duties are fundamental principles of partnership law and so, sponsors of the analogy contend, also should be fundamental principles of the law of closely held corporations.").

[84] S*ee* McCahery, *supra* note 5 (discussing the growth of new types of business organizations in both the United States and in Europe).

[85] *See* Djankov et al., *supra* note 6 (introducing the regulation of entry methodology to compare business registration requirements across countries).

this hypothesis.[86] Emphasis on the registration of *businesses*—as opposed to *corporations*—has distanced the academic and policy discussion from the role of corporate law in the governance of non-listed companies, guiding it towards the relationship between such entry requirements and entrepreneurship.[87] Overall, interest in new legal forms and business registration reforms has increased at the expense of the study of corporate law and its influence in the governance of non-listed firms—notably, startups.

C. Corporate Governance and Venture Finance: A World of Contracts

The apparent irrelevance of corporate law also contributed to the emergence of the now dominant field of corporate governance, which explores corporate behavior and its relationship with various legal regimes, markets and institutions.[88] Despite introducing new

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[86] *See*, *e.g.*, Carsten Gerner-Beuerle et al., *Why Do Businesses Incorporate in Other EU Member States? An Empirical Analysis of the Role of Conflict of Laws Rules*, 56 INT'L REV. L. & ECON. 14–27 (2018) (investigating how and why companies opt to incorporate in various different European Union member states); Wolf-Georg Ringe, *Corporate Mobility in the European Union—a Flash in the Pan? An empirical study on the success of lawmaking and regulatory competition*, 10 EUR. CO. & FIN. L. REV. 230–267 (2013) (exploring how various European Union countries have enacted regulatory reforms to discourage domestic companies from incorporating in foreign countries); Reiner Braun et al., *Does Charter Competition Foster Entrepreneurship? A Difference-in-Difference Approach to European Company Law Reforms*, 51 J. COMMON MARKET STUD. 399–415 (2013) (exploring the impact minimum capital requirement regulations have on entrepreneurs' selection of jurisdiction of incorporation); Marco Becht, Colin Mayer & Hannes F. Wagner, *Where do Firms Incorporate? Deregulation and the Cost of Entry*, 14 J. CORP. FIN. 241–256 (2008) (examining the impact of deregulation on jurisdiction of incorporation decisionmaking); LEORA KLAPPER, LUC LAEVEN & RAGHURAM G RAJAN, *Business Environment and Firm Entry: Evidence From International Data*, 63 (2004) (finding that countries with comparatively high barriers to entry tend to have slower economic growth); Djankov et al., *supra* note 6.

[87] *See* Pereira, *supra* note 50 (examining the relationship between entry costs and the fostering of a strong entrepreneurial environment).

[88] Ronald J. Gilson, *From Corporate Law to Corporate Governance*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 3, 4 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) (observing that, since the 1960s and 19070s, scholars in both law and finance agree that corporate law is

frameworks that illuminate the understanding of corporations,[89] studies in corporate governance have predominantly focused on listed companies, because of their homogeneity, the availability of data that they are legally required to disclose, and the salience of corporate scandals affecting investors.[90] While the strength of the corporate governance debate[91] has prompted the adaptation of certain rules designed for listed corporations to non-listed ones,[92] the prevailing account still sustains that private firms are governed either by a set of enabling rules from which parties can opt-out,[93] or, where

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insufficient to explain the behavior of corporations, giving rise to new frameworks that integrate markets and institutions).

[89] For instance, how firm performance is affected by independent directors or different forms of executive compensation. Two seminal works in these topics are, respectively: Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465–1568 (2006) (examining the origins and justifications of the general trend towards boards comprised of mostly independent directors); JESSE FRIED & LUCIAN BEBCHUK, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (analysing the influence corporate executives have over the decisions made by the board of directors).

[90] Fleischer, *supra* note 7 at 680–81.

[91] Gilson, *supra* note 90 at 5 ("[M]ore than a quarter of all articles published in the Journal of Financial Economics, one of the two leading finance journals, from 1995 through August 29, 2013 were related to corporate governance.")

[92] Joseph A. McCahery & Erik P.M. Vermeulen, *Corporate Governance and Innovation - Venture Capital, Joint Ventures, and Family Businesses* (European Corporate Governance Institute - Law Working Paper No. 65, 2006) ("the costs of designing corporate governance structures that minimizes the expected risks of opportunism and can be enforced by judicial process may be prohibitively high. Thus, policymakers, investors, lenders and other stakeholders prefer to recommend the application of the corporate governance rules and principles tailored to the requirements of publicly held companies.").

[93] The traditional proposition is described in: Easterbrook & Fischel, *supra* note 84. A contemporary debate in the U.S., derived from this approach, is the extent to which managers and controlling shareholders of non-listed companies should be allowed to waive their fiduciary duties. Supporters of such a waiver defend the right of a "limited number of participants" to contract out of corporate law. Such a discussion has proved difficult to advance from a comparative perspective, due to the significant differences

there is a menu of corporate forms, by rules that enable parties to opt-in, selecting a given form.[94]

An enabling account of corporate law also prevails in the venture finance literature, which predominantly focuses on the financing of startup companies.[95] Unlike studies on business forms and corporate governance, this body of research acknowledges the separation of ownership from control in some non-listed firms.[96] Still, cross-country analysis of contractual arrangements distributing economic and control rights among firms' participants seldom inquire whether corporate law allows the creation or adjustment of those rights.[97] Although some empirical studies do explore or

in the regulation of fiduciary duties, both substantially and procedurally. For an overview of the discussion, see Daniel S. Kleinberger, *Two Decades of Alternative Entities: From Tax Rationalization through Alphabet Soup to Contract as Deity*, 14 FORDHAM J. CORP. & FIN. L. 445 (2009) (examining the limits of "freedom of contract" in the context of fiduciary duties of closely held corporate entities); Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 B.U. L. REV. 701 (2011) (exploring the ongoing debate involving waiver of fiduciary duties by different types of corporate entities under Delaware law).

[94] Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence From LLCs*, 73 WASH. U. L. Q. 369–432 (1995) (discussing potential changes to tax regulations that could grant corporate entities greater flexibility in structure).

[95] For a comprehensive overview of the main literature, see Marco Da Rin, Thomas Hellmann, & Manju Puri, *A Survey of Venture Capital Research,*, *in* HANDBOOK OF THE ECONOMICS OF FINANCE 573–648 (George M. Constantinides, Milton Harris, & Rene M. Stulz eds., 2 ed. 2013).

[96] In fact, it is often described as a *necessary* feature for companies financed through equity. *See, e.g.*, Erik Berglof, *A Control Theory of Venture Capital Finance*, 10 J. L. ECON. & ORG. 247–267 (1994) ("the allocation of returns and control . . . protects the initial contracting parties as much as possible against dilution and extracts from a future buyer of the firm"); *see also* George W. Jr. Dent, *Venture Capital and the Future of Corporate Finance*, 70 WASH. U. L.Q. 1029, 1029–1086 (1992) ("A venture capitalist supplies equity financing but does not assume control of the enterprise.").

[97] For example, it is common to find references to debt that is automatically converted to stock once an agreed condition is met, a common provision in U.S.-style financing contracts that could have limited application if corporate laws instead subject conversion to mandatory board or shareholder approval. In one of the most influential of such empirical studies, Kaplan and co-authors concede that their findings simply "*indicate*

consider the legal determinants of equity investments in private companies, most of them rely on investor protection indexes, largely based on the laws and regulations of listed companies, on rankings of legal systems' efficiency in enforcing contracts or broader measures of the rule of law.[98]

It is particularly concerning that contemporary venture finance studies measuring the impact of cross-country differences in corporate law and governance[99] rely on indexes distinguishing systems by "legal origins."[100] Such a classification has not only been widely criticized but also debunked by the legal academic community,[101] an indication that its use might have led to

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VCs are able to write (and *presumably* enforce) contracts [with contingent control]" (stress added). Kaplan and Strömberg, *supra* note 22, at 294.

[98] *See*, *e.g.,* Kaplan, Martel, & Strömberg, *supra* note 2 (using indexes on investor protection, rule of law and creditor protection—all based on the "legal origin" hypothesis—to account for differences in laws and institutions); Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity**, 120 Q.J. ECON. 223–246 (2005) (using "legal origin" to classify legal systems' influence in the content of private equity contracts).

[99] *See*, *e.g.*, Kaplan, Martel, & Strömberg, *supra* note 2 (comparing venture finance in in Britain and France); Douglas Cumming, Daniel Schmidt & Uwe Walz, *Legality and Venture Capital Governance Around the World*, 25 J. BUS. VENTURING 54–72 (2010) (including evidence of "legal origin" in analysis of new dataset on investments of venture capitalists); Theodore A. Khoury, Marc Junkunc & Santiago Mingo, *Navigating Political Hazard Risks and Legal System Quality: Venture Capital Investments in Latin America*, 41 J. MGMT. 808–840 (2015) (utilizing the Henisz political hazard index to compare the legal system quality of Latin American nations).

[100] Notably, Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113–1155 (1998) (comparing the rights of shareholders in nations with different legal origins).

[101] *See*, *e.g.*, Holger Spamann, *The "Antidirector Rights Index" Revisited*, 23 REV. FIN. STUD. 467–486 (2010) (pointing out that La Porta's empirical results were established using an index may not be replicable); John Armour et al., *Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis*, 6 J. EMPIRICAL LEGAL STUD. 343–380 (2009) (pointing out weaknesses in La Porta's research); Katharina Pistor, *Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies*, 1 EBOR 59–107 (2009) (concluding that shareholders do not

inaccurate—yet influential—findings on the extent to which differences in corporate laws can affect the governance structures and financing opportunities of startup companies.[102]

D. The Renewed Value of Corporate Laws

Despite differing in their conception of the private business enterprise and their influence in scholarship and policy, all previous accounts concur in two assessments. First, that the corporate form is likely irrelevant for the governance and financial structure of non-listed firms because those matters are in the domain of contracts. Second, that corporate law is inconsequential or uninteresting because it merely contains enabling rules from which parties can (and often do) contract out. The pervasiveness of these views explains why differences in corporate laws have not been explored by the comparative literature on the governance of non-listed firms and, notably, of startup companies.

The facts, however, indicate that both propositions are incorrect. First, most startups adopt the corporate form,[103] even when

necessarily enjoy the most rights in common law nations, as La Porta suggested).

[102] *See*, *e.g.*, J. Lerner & J. Tag, *Institutions and Venture Capital*, 22 INDUS. & CORP. CHANGE 153–182 (2013) (using the U.S. and Sweden as case-studies to challenge the literature's main findings on the role of institutions—including law: "Our literature survey underscores that the legal environment, financial market development, the tax system, labor market regulations, and public spending on research and development correlate with venture capital activities across countries.").

[103] Indicative of it is that venture capital associations in their model legal documents for new companies recommend the corporate form. *See*, *e.g.*, NAT 'L VENTURE CAP. ASS 'N, *Model Legal Documents*, NVCA (2020) nvca.org/model-legal-documents/ (last visited Feb 19, 2022) (providing model documents with corporate language in them); BRITISH PRIVATE EQUITY & VENTURE CAP. ASS 'N, *Model Documents for Early Stage Investments*, BVCA (2020) bvca.co.uk/Policy/Tax-Legal-and-Regulatory/Industry-guidance-standardised-documents/Model-documents-for-early-stage-investments (last visited Feb 19, 2022). The preeminence of the corporate form is also apparent in directories of startup and venture-backed companies in different countries. *See*, *e.g.*, LAT. AM. VENTURE CAP. ASS'N, 2019 LAT. AM. SATRTUP DIRECTORY, lavca.org/vc/startup-directory/ (last visited Feb 19, 2022) (offering a list of

that decision reduces tax savings.[104] Moreover, virtually all of those firms are financed through the issuance and selling of shares to investors,[105] one of several distinguishing elements of the corporate form that is not replicable through contract.[106] Hence, from an organizational perspective, it appears that the increasing significance of startup companies owes a great deal to the corporate form.

Secondly, while it is tempting to conclude that corporate laws are generally homogeneous (after all, the corporate form has the same essential features everywhere) and that differences are trivial (if participants can, in fact, opt-out), there is evidence that variations in specific rules might frustrate crucial governance and financial arrangements among shareholders.[107] Empirical evidence further shows that, whenever possible, entrepreneurs prefer jurisdictions perceived to have higher flexibility in corporate law,[108] which

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over 300 private firms "in operation that have reported US$1m+ in funding to [Latin American Venture Capital Association] as of Jan. 1, 2019.").

[104] *See* Joseph Bankman, *The Structure of Silicon Valley Start-Ups UCLA Tax Policy Conference*, 41 UCLA L. REV. 1737–1768 (1993) (finding that "equity" is a major factor behind Silicon Valley investors' preference for the corporate form, notwithstanding the tax benefits reserved to other legal forms in the United States).

[105] *See* FLORIDA & HATHAWAY, RISE OF THE GLOBAL STARTUP CITY (2018) (discussing the rise of eventual capital investing in startup across the globe).

[106] *See infra* Section V.A. *See also* John Armour & Michael J. Whincop, *An Economic Analysis of Shared Property in Partnership and Close Corporations Law Symposium: Unincorporated Business Entities*, 26 J. CORP. L. 983–1000 (2000) (explaining that corporate law has other foundational terms non-replicable by contract, including legal rules on agency, proprietary entitlements and insolvency).

[107] For example, before 2000, Japanese corporate laws prevented investors from exercising control through preferred stock privileges and limited entrepreneurs' ability to strengthen their commitment to the business—e.g., by conditioning the transferability of their stock to vesting plans. Overall, these limitations constrained future deals, preventing or delaying the development and entrance of certain businesses into the market: "In fact, Japanese VCs invest less . . . than one-tenth of the US average." Shishido, *supra* note 10, at 1090.

[108] *See*, *e.g.*, Gerner-Beuerle et al., *supra* note 88; Ringe, *supra* note 88; Braun et al., *supra* note 88; Becht, Mayer, & Wagner, *supra* note 88; Roberta Romano, *The State Competition Debate in Corporate Law Conference*, 8 CARDOZO L. REV. 709–758 (1986) (finding that Delaware "is

indicates that the law could also condition the governance structure of these firms.

Reviewing startup finance and governance through the lens of founders and financiers exposes the relevance of fundamental features of the corporation and corporate law that are not replicable by contract, and thus could explain VC deal patterns and structure in different countries and stages. Identifying such features is also a first step to exploring whether unnoticed changes might be affecting other types of non-listed firms.

IV. A Founder's Legal Journey to Business Growth

Startups are different from other private firms. They are designed to rapidly capture, disrupt or create new markets.[109] Meeting these goals requires extraordinary influxes of capital that cannot be supplied either by traditional lenders (due to high risks, lack of assets or revenue), nor by traditional equity investors (given the limited disclosure and liquidity of private markets).[110] Instead, most successful startups are financed by investors with high-risk tolerance who share control of the company at different stages of its life cycle.[111] In each stage, founders and investors must overcome their mutual distrust (*double trust-dilemma* or *double-agency problem*).[112] A balance between their interests is crucial. Without it, many innovative ideas might never develop to enter the market. An

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the most frequent location for a reincorporation-as excessively permissive, by which they mean tilted toward management.").

[109] Joshua Gans, Erin L. Scott, and Scott Stern, *Strategy for Start-ups*, HARV. BUS. REV. (May-June 2018), hbr.org/2018/05/strategy-for-start-ups [perma.cc/NL56-QSL4] (describing various strategies and their context for startups).

[110] *See generally* GOMPERS & LERNER, *supra* note 37.

[111] Pollman, *supra* note 35, at 161 ("Because startups are often unprofitable for long periods while they develop innovative products or services, they usually raise outside investment and continue to do so to fuel growth. Each round of financing may bring investors with different terms and interests into the capital structure, adding to potential governance conflicts.").

[112] On the double-trust dilemma and the earlier economic theories on double-agency problems, see COOTER & SCHÄFER, SOLOMON'S KNOT: HOW LAW CAN END THE POVERTY OF NATIONS, PRINCETON UNIV. PRESS, 27–38 (2012) (explaining the double trust dilemma as "the innovator must trust the investor not to steal his idea, and the investor must trust the innovator not to steal his capital").

ideal scenario is a trust-enhancing deal, whereby founders are encouraged to develop the business and investors feel safe with providing additional capital or welcoming new investors to finance growth and expansion. An unbalanced deal might discourage the founder, the investor or both.

A vast financial contracting literature has identified pervasive issues that exacerbate distrust and threaten startup finance.[113] For example, parties' inability to access the same information or rely on other's intention to share it (*information asymmetries*), and the impossibility of setting up comprehensive rules for every possible outcome (*incomplete contracting*).[114] Similarly, the difficulty of controlling opportunistic behavior from those with decision-making powers (*agency problems*) and discourage excessive risk exposure by those who do not bear the costs of the decision (*moral hazard*).[115] To be sure, these are issues inherent to all business ventures, but they are intensified by the high-risk nature of startups. And, while the diagnosis is useful to examine how participants overcome them, scrutiny has mainly focused on the contractual solutions developed by VCs, with insufficient attention to the legal rules that frame bargains between startups' founders and investors.

By examining the trade-offs that they have to make, this section reveals that corporate law is vital for trust-enhancing deals in three crucial stages of a startup's life cycle: *registration, seed finance,* and *venture capital finance*.

A. Registration

[113] For an overview, see Da Rin, Hellmann, & Puri, *supra* note 97.

[114] Oliver Hart, *Financial Contracting*, 39 J. ECON. LITERATURE 1079, 1079–1100 (2001).

[115] *Id*. (discussing issues that occur in startup finance between those providing capital and those making decisions); s*ee also* Philippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59 REV. ECON. STUD. 473 (1992) (illustrating the incomplete nature of financial contracting using economic models); Susheng Wang & Hailan Zhou, *Staged financing in venture capital: moral hazard and risks*, 10 J. CORP. FIN. 131–155 (2004) (discussing "staged financing in an environment where an entrepreneur faces an imperfect capital market and an investor faces moral hazard and uncertainty.").

Founders' first decision is to register a company. It accomplishes two crucial purposes: protecting personal and business assets, and enabling venture finance.[116] While founders have control of this decision, the wrong choice might further diminish investors' trust, requiring costly restructuring and minimizing the firm's ability to access external finance. Founders must not only consider how this decision impacts immediate funding, but how it might affect their ability to attract investors at different stages of the business life.

Among all legal entities, the corporate form contributes to enhancing founder-investor trust in three ways. First, by providing strong separation of assets, reducing participants' risk exposure (*limited liability*) and protecting the business from participants' liabilities (*entity shielding*).[117] Second, it enables the business to capitalize through the issuance and selling of transferable shares to investors (*equity finance*), which is particularly important for startups requiring various rounds of investments to finance expansion efforts without compromising investors' ability to exit (i.e., liquidate their investments).[118] Third, corporate law contributes to ameliorating issues of information asymmetries and incomplete contracting, without increasing the costs of bargain among startup founders and financiers, by defining shareholders' information rights and how business decisions are taken and executed.[119]

These legal properties of the corporation are either absent or weaker in other organizational forms, making it more costly and less certain to reach through contract. Partnerships and certain hybrid forms have, by default, equal-sharing rules, which require complex contracting to establish similar trust-enhancing protections, not only

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[116] Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations Symposium: Team Production in Business Organizations*, 24 J. CORP. L. 913–948, 916 (1998) (discussing the problem of protection of minority shareholders that occurs in a closely held corporation, and to what extent the law should provide protection for minority shareholders).

[117] *See supra* Section III.A.

[118] On liquidity events, see Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967–1025, 970 (2006) ("In contrast, VCs investing in U.S. startups almost always receive convertible preferred stock with substantial liquidation preferences.").

[119] *See* Hart, *supra* note 121 (discussing how corporate law ameliorates information asymmetries inherent in financial contracting).

increasing transaction costs but also the risk of litigation.[120] Other hybrid forms, such as limited liability companies also have shortcomings. For one, they differ from country to country, making it more costly to define the basic terms of agreement, further increasing distrust.[121] They also have restricted access to public equity markets, which is the ideal exit option for late-stage investors.[122] Finally, because alternative legal entities are not generally designed for large-scale businesses but instead for closely-related participants, judges would likely be less prone to enforce private agreements that create imbalances among shareholders, even if they were aimed at facilitating access to external finance.[123] These properties explain why the corporate form is required by investors around the world, and preferred by founders, even when it is costlier.[124]

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[120] *See* EASTERBROOK & FISCHEL, *supra* note 68; analysis in Section III.B.

[121] *See* Pereira, *supra* note 50, at 443 (". . . [C]orporations must adhere to stricter and more costly governance standards in many jurisdictions . . . "); Fleischer, *supra* note 7, at 685 ("Many countries have independent codes for their limited liability companies."); Joseph A. McCahery, Erik P. M. Vermeulen & Priyanka Priydershini, *A Primer on the Uncorporation*, 14 EUR. BUS. ORG. L. REV. 305, 314 (2013) (listing differences in how different countries approach limited liability companies and their requirements).

[122] Rock & Wachter, *supra* note 123 ("In their view, participants choose the corporate form over the partnership form simply to take advantage of limited liability. The problem with close corporation law, they argue, is that despite this functional equivalence, shareholders cannot exit their investment as easily as partners who always have the power to trigger a buyout. . . . ").

[123] *See* Pereira, *supra* note 50, at 445 (" [T]he 'partnership-type' forms, which grant the benefit of pass-through tax treatment but generally require unanimous approval for interest transferability, and, by default, require profits and losses to be distributed evenly among members. . . . "); Bankman, *supra* note 108 (discussing the disadvantages to alternative business entities when they grow too large).

[124] *See* Pereira, *supra* note 50, at 441 ("The corporation is the most prominent business legal form."); Bankman, *supra* note 108 ("On the other hand, the lack of interest in tax is also consistent with hypothesis that the industry structure is optimal. A stand-alone corporation may offer significant advantages that outweigh the tax costs."); NVCA, *supra* note 107 (offering "industry embraced model document[s]" for the United

The corporate form is therefore vital for startup financing, which has two implications. First, the costs of creating and operating a corporation should be considered when analyzing a legal system's ability to support a startup ecosystem. Second, a comparative review of financing contracts should account for these differences. Legal systems with high regulatory costs for corporations (not for any business entity) likely induce early-stage startups to adopt other organizational forms and transform later, a path that might lead to variations in the agreements that parties reach to enhance trust or even to unbalanced agreements. It might also explain cross-country differences in the volume of early-stage finances.

B. Seed Finance

Once a business is incorporated, founders must confront the difficulty of financing the development of a promising but untested idea. Because more mature companies are likely in a better position to transform an innovative concept into a profitable business, founders have a strong incentive to preserve secrets from financiers.[125] This circumstance makes early-stage startups generally unsuited for debt finance and for crowdfunding.[126] It also elevates the distrust between founders and potential investors to a dilemma: despite desperately needing finance, founders have a strong interest in preserving secrets and control; and even investors with a high-risk tolerance and an appetite for exceptional returns might not be willing

States); BVCA, *supra* note 107 (providing "industry standard legal documentation" for the United Kingdom); LAVCA, *supra* note 107.

[125] Hall & Lerner, *supra* note 14 (". . . the primary output of resources devoted to invention is the knowledge of how to make new goods and services, and this knowledge is nonrival: use by one firm does not preclude its use by another." This means if other people got the information about a company, they could use it, thus the founder does not want them to have it).

[126] John Armour & Luca Enriques, *The Promise and Perils of Crowdfunding*, at 6 (European Corp. Governance Inst., Working Paper No. 366/2017, 2017) ("Start-ups generally do not generate steady cash flows to pay interest and—beyond re-mortgaging the founder's family home—lack liquid assets to offer as security. This makes them unattractive candidates for corporate debt financing . . . .").

to provide capital without sufficient information to evaluate the risk and participation in control to protect their investment.[127]

At this stage, a common solution to this dilemma is found in convertible debt, which is essentially an agreement through which private investors (e.g., angel investors, incubators) lend small amounts of capital to the startup company, allowing it to offer shares in case it cannot repay at the maturity date or at investors' will.[128] As such, convertible debt allows capitalization with little compromise from either party: founders can preserve control over the development of the idea, and investors cap their risk exposure by committing small amounts of capital and establishing a repayment instead of equity.[129] By deferring the share price to a future valuation, parties also reduce transaction costs and avoid issues that derive from incomplete contracting.[130] Variations to this standard agreement may include investors' right to participate in subsequent rounds of investments at a discount or founders' right to extend the maturity date to avoid bankruptcy.

Investment agreements that defer the purchase of the shares are an increasingly popular alternative.[131] These agreements also allow founders to preserve control, while providing more flexibility, as they are not subject to debt regulations, which may include short

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[127] Robert Cooter & Hans Bernd Schäfer, *The Secret of Growth Is Financing Secrets: Corporate Law and Growth Economics*, 54 J.L. & ECON. S105–S123, S106 (2011) ("The investors fear losing their wealth, and the innovators fear losing their secrets. This is the double trust dilemma of development . . . .").

[128] John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 133–182 (2014) (asserting that convertible debt investments in early-stage companies are effectively deferred equity investments).

[129] *Id.*

[130] *See* Gompers, *supra* note 36 (describing how convertible securities can be used to reduce costs resulting from informational asymmetries).

[131] *See* John F. Coyle & Joseph M. Green, *The SAFE, the KISS, and the Note: A Survey of Startup Seed Financing Contracts Essay*, 103 MINN. L. REV. HEADNOTES 42–66 (2018) ("Over the past decade, there has been an explosion in seed financing for early-stage technology startups. Increasingly, this seed financing is channeled to these companies via an entirely new form of investment contract—the deferred equity agreement".).

and fixed term requirements, specific calculation of the interest rates, and limitations on how such interests may be converted into equity.[132]

Although convertible debt and other instruments that defer share purchases are essentially contractual, corporate law determines the credibility of their commitments conditioning the protection of participants and future investors. First, by establishing the requirements to issuing new shares.[133] These may include mandatory rules requiring shareholder approval of share issuances, and preemptive rights to purchase newly issued shares or limits to the percentage of shares that can be reserved for those purposes.[134] These and other type of mandatory rules are trust-constraining, as they subject the contract's performance to an additional control that may lead to delays or even breach of contract, depriving them of the opportunity to receive and exercise their voting rights in a timely manner.[135]

Conversion or the right to acquire new shares may also be triggered by a new round of finance.[136] In those cases, the board may decide to repay instead of issuing shares or intervene in the valuation of debtors' shares. Judicially enforcing a contractual obligation subject to a legal condition is certainly harder and longer than simply enforcing an obligation that is not subject to such restrictions. To control for these risks, investors might (and in fact, generally do)

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[132] *Id.*; *see also* Carolynn Levy, *YC Safe Financing Documents*, Y COMBINATOR (2018), ycombinator.com/documents [perma.cc/A35H-QJXK] (describing the model agreement recommended by Y Combinator and providing templates for the United States, Singapore and Canada); *and* 500 Startups, *500 Startups KISS Convertible Debt & Equity Documents*, COOLEY GO, cooleygo.com/documents/kiss-convertible-debt-equity-agreements/ [perma.cc/PUJ5-YC9M] (offering model convertible debt and equity agreement drafts for US startups).

[133] For a comparative analysis on the corporate rules on share issuances, see Marco Ventoruzzo, *Issuing New Shares and Preemptive Rights: A Comparative Analysis*, 12 RICH. J. GLOB. L. & BUS. 517, 517–542.

[134] *Id.*

[135] Unlike shareholders with preemption rights, who can enforce them internally against directors, blocking or revoking an issuance, purchasers of convertible debt or of rights over new issuances have a contractual claim against the company, which must be enforced externally and may result in cash (and not shares, i.e., not control) compensation. *See*, *e.g.*, Levy, *supra* note 139.

[136] *Id.*

require founders to sign a shareholders' agreement.[137] Here, corporate laws also frame these bargains, delimiting the substantive and procedural requirements to enforce shareholders' agreements on voting.[138]

An additional aspect that may influence the use of convertible debt or similar instruments is the costs of issuing these privately offered shares. While these are generally immaterial, there is an indication that they may induce early-stage startups to delay equity finance or rely on alternative sources of capital.[139]

Minor disparities in these unexplored areas might explain cross-country differences in the volume of early-stage finance and patterns in financing agreements, including the absence of convertible-debt. They might also further encourage certain founders to select legal forms that are ill-equipped to finance rapid expansion, if the idea is successfully developed at this stage.

C. Venture Capital Finance

Once an idea has developed into an innovative product or service, the company must secure funds to enter the market competitively and sustain a continuous business expansion. A minimum viable product, a small customer base and a stable revenue might alleviate investors' distrust and improve founders' bargaining powers.[140] Still, financing rapid growth requires large amounts of capital at subsequent stages, which entail new challenges.[141] The company must prepare a credible valuation, sufficiently high to fund short-term milestones without financial distractions, and a projected capital structure where immediate and future investors can participate

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[137] *See* Section IV.D.
[138] *See id.*
[139] *See*, *e.g.*, Lars Hornuf, Tobias Schilling & Armin Schwienbacher, *The Relevance of Investor Rights in Crowdinvesting*, J. CORP. FIN. 101927 (2021) (describing how high-costs of share transfer influences German startups to "often use mezzanine financial instruments").

[140] Anecdotal accounts are available in TOM NICHOLAS, VC: AN AMERICAN HISTORY (2019).

[141] Gompers & Lerner, *supra* note 37 ("[T]he duration of a particular round . . . the size of each investment, total financing provided, and number of financing rounds are . . . important measures of the staged investment structure.").

along with founders and key employees.[142] Still, founders risk being diluted. Finance might not flow when needed, jeopardizing the company's growth, competitiveness or even survival. Key employees might leave, disturbing the business' operations and compromising milestones. Investors are also exposed to dilution and moral hazard, in addition to the pressing uncertainty of not realizing their investment.

The venture capital industry has developed strategies to overcome these challenges, allowing startups to access funds (and fail), while minimizing their own losses from unsuccessful businesses and participating in the gains from those who have extraordinary performance.[143] To reduce the downside risk, VCs do not provide all the required capital at once, but instead supply it in different stages, subject to meeting specific milestones.[144] They also have direct participation in the business' governance and require performance-based compensation structures to attract and retain

[142] Seth C. Oranburg, *Start-up Financing*, *in* START-UP CREATION 59–79 (Fernando Pacheco-Torgal et al. eds., 2020) ("[I]f the valuation is too high, then the note holder will effectively get a massive discount vis-à-vis the next equity investor.").

[143] The characteristic "long-tail" distribution payoffs is possible due to a variety of factors, chief among them, superior industry knowledge and the use of control rights. For a thorough account of the origins of these investment strategies in the United States, see generally NICHOLAS, *supra* note 152, at 1–10 (summarizing origins of venture capital industry and strategies used to offset entrepreneurial risks associated with "allure of the long tail").

[144] *See id*. at 4 (illustrating venture capitalists similarities in payment disbursement as early 19th century whaling ventures); *see also* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 319 (2005) ("[V]enture capitalists typically would have limited their exposure to harm because they stage their financing of the venture, providing only partial funding during the initial stage, with increased funding at subsequent stages."); Gilson, *supra* note 59, at 1078–1081 (summarizing the staged financing system); Gompers, *supra* note 37, at 1464 ("Each time capital is infused, contracts are written and negotiated, lawyers are paid, and other associated costs are incurred. These costs mean that funding will occur in discrete stages.").

talent.[145] To secure returns, they establish protections against dilution and preferential rights to liquidate their investments.[146] All these terms are also contingent on VC funds' own 7–10-year lifespan, by the end of which investors will seek to realize their investment (divest), whether by selling their shares at a premium or the company as a whole.[147] These are harsh terms for most entrepreneurs and ordinary firms. However, they offer ambitious founders a unique opportunity to finance scalable innovative businesses.

VC finance is structured in various contracts regulating investors' participation in the startup company; as such, the scope of their rights and the strength of such commitments is subject to corporate law.[148] By investing in corporations, VCs not only avoid bargaining over basic—yet indispensable—organizational aspects discussed in Section IV.A, but also opt for a standard design against which they can negotiate downside and upside protections, and customize the company's governance and capital structure to the fund's lifespan.[149]

The regulation of corporate boards is crucial for these objectives. Boards are at the heart of corporations' governance, entrusted with hiring and monitoring executive offices, and initiating fundamental transactions, such as equity issuances.[150] Thus, board representation gives investors powers to decide, on the one hand, the type of shares that employees and founders might receive (e.g., preferred, restricted, shadow) and when (i.e., vesting), and, on the

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[145] On stock options, see Paul Oyer & Scott Schaefer, *Why do Some Firms Give Stock Options to All Employees? An Empirical Examination of Alternative Theories*, 76 J. FIN. ECON. 99, 104–06 (2005) (emphasizing the importance of stock options in increasing overall compensation for both executives and non-executives).

[146] Thomas Hellmann, *IPOs, acquisitions, and the use of convertible securities in venture capital*, J. FIN. ECON. 649, 657–58 (2006) ("In practice, it would be very difficult to pre-specify exit decisions, so that venture capital contracts always allocate control rights over exit decisions. The reason for this is presumably that there are additional actions, not formally modeled here, that are necessary for implementing exit decisions (e.g., finding and bargaining with an acquirer).").

[147] *See generally id*. (reviewing aforementioned elements and describing how they fit into Hellman's model).

[148] *See supra* Section IV.A.

[149] *See id.*

[150] *See infra* Section IV.B.

other, defining and reviewing business milestones that justify additional rounds of investments, and the conditions under which new investors might be welcomed. By empowering the board to issue shares for future capitalizations, contracting parties avoid negotiation of specific and unpredictable circumstances, minimizing the frictions generated by incomplete contracting.[151] For investors, shared control over these decisions allows them to reduce agency costs and moral hazard.[152] For founders, it is an opportunity to raise funds without surrendering the majority of voting shares or complete control.[153] While there is no one-size-fits-all formula, representation in a powerful board ensures direct influence in key decisions, which participants will consider when pricing the investment. Rigid corporate law rules on boards' election, composition and powers reduce VCs' ability to establish governance-based protections, which might either lead to trust-constraining alternatives (e.g., purchasing the majority of the shares) or deter them entirely from venturing with the entrepreneur in a given jurisdiction.

Corporate law also supports trust-enhancing agreements through the regulation of shares. Shares provide their holders' rights over the firm's future net earnings (or residual claims to its assets, if

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[151] *See* Fried & Ganor, *supra* note 125 at 979 ("As long as the preferred contractual rights are respected, the board is free to take steps that impose substantial costs on preferred shareholders in order to benefit the common shareholders.").

[152] Industry experts, Brad Feld and Jason Mendelson highlight that it is almost an investment precondition: "VCs will often want to include a board observer as part of the agreement either instead of or in addition to an official member of the board." BRAD FELDAND & JASON MENDELSON, 2 VENTURE DEALS: BE SMARTER THAN YOUR LAWYER AND VENTURE CAPITALIST, 68 (John Wiley & Sons, 2019). For Scott Kupor, managing partner at Anderssen Horowitz, one of the world's largest venture capital funds, it is essentially about retaining and using control at the expense of shareholders with different priorities: "[P]robably the most foundational thing that a board does is to hire [or fire] the CEO. Understandably so, many founder CEOs have been paying much more attention to the composition of the board of directors given historical concerns over VCs being quick to replace the founder CEO." SCOTT KUPOR, SECRETS OF SAND HILL ROAD: VENTURE CAPITAL AND HOW TO GET IT, 171 (2019).

[153] *See* Kaplan and Strömberg, *supra* note 22 (finding, in a sample of 118 Silicon Valley startups, that in 60% neither investors nor founders had control of the corporation).

it goes insolvent) and rights to participate in the governance of the corporation, through the election of the board and approval of both annual financial statements and fundamental transactions.[154] In principle, each share is entitled to one vote, which ensures that those who hold more shares have more economic and control rights.[155] Most jurisdictions allow the creation of preferred shares, which grant higher economic rights at the expense of controlling rights (e.g., preferred dividend, no vote) or vice versa (e.g., double vote, restricted dividend);[156] and some jurisdictions allow the creation of different classes and series of shares, whose rights and obligations are regulated in the corporate charter.[157] In the latter scenario, shares

[154] *See supra* Section III.A.

[155] *See generally* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 408 (1983) (highlighting the "one share-one vote" concept as a basic presumption). For a review of theoretical developments and empirical evidence of the impact of the one-share one-vote rule, see, respectively: Mike Burkart & Samuel Lee, *One Share - One Vote: the Theory**, 12 REV. FIN. 1–49 (2008); René Adams & Daniel Ferreira, *One Share - One Vote: The Empirical Evidence*, 12 REV. FIN. 51–91 (2007).

[156] For a comparative analysis see Aurelio Gurrea-Martínez, *Theory, Evidence, and Policy on Dual-Class Shares: A Country-Specific Response to a Global Debate*, EUR. BUS. ORG. L. REV. 476 (2021); *see also* Lucian A. Bebchuk, Reinier Kraakman & George Triantis, *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORP. OWNERSHIP, 295–318 (Randall K. Morck ed., 2000) (identifying dual-class stock as an important mechanism to exercise control); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-country Analysis*, 68 J. FIN. ECON. 325 (2003) (offering empirical evidence of the value of increased voting rights in 661 dual-class listed firms in eighteen countries). Two influential theoretical accounts are: William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 UNIV. PA. L. REV. 1815 (2013) (postulating preferred stock as a part of both corporate and contract law); Richard M. Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CAL. L. REV. 243 (1954) (examining the creation and protection of rights within shares of preferred stock).

[157] Despite the absence of a comparative study on the specific *legal* provisions allowing charter regulation of shares in various jurisdictions, there is evidence that they are included in investment agreements. *See, e.g.*, BEAT BRECHBÜHL & BOB WOODER. GLOBAL VENTURE CAPITAL TRANSACTIONS: A PRACTICAL APPROACH 14 (ASSOCIATION INTERNATIONALE DES JEUNES AVOCATS

might operate as trust-enhancing instruments for heterogeneous groups of shareholders with divergent priorities.[158] For investors, shares with preferred rights (e.g., multiple votes or priority in case of liquidation) can protect them from downside risks without the need to hold a controlling majority.[159] When the company is doing well, rights of first refusal secure them participation in subsequent financing rounds, and automatic conversion to common stock in a pre-defined liquidity event (e.g., an IPO or a merger) ensures return on investment.[160] When the VC fund is approaching the end of its lifespan, redemption rights might allow investors to realize the investment in a well-performing company that is not ready for a liquidity event, and drag-along rights might even allow them to force a sale.[161] Enhanced freedom to issue and regulate various series and classes of shares also enables founders to keep the majority of the

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2004) ("[E]xisting shareholders or shareholder groups frequently have contractual approval or pre-emptive rights that could affect the proposed vc investment . . . ."); Cumming, Schmidt, and Walz, *supra* note 101 (examining the legality of various shareholder rights); Kaplan, Martel, and Strömberg, *supra* note 2 (analyzing VC contracts regarding various control rights); Lerner and Schoar, *supra* note 100 (examining the role of contract in contingencies regarding shareholder rights); Coyle & Green, supra note 138 (describing how they emerged in the United States).

[158] *See, e.g.*, Bratton and Wachter, *supra* note 174 (describing how preferred stocks are designed to control the board).

[159] *Id.; see* Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78 BROOK. L. REV. 1163, 1172–75 (2012) (describing the usage of preferred stock in comparison to common stock); William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100 MICH. L. REV. 891, 894–905 (2002) (stressing that contract law may not be enough to protect VC's with preferred stock and no controlling majority).

[160] Hellmann, *supra* note 162, at 650 ("The curious aspect of this security is that an investor would never want to convert, since the rights to a preferred dividend simply vanish. This shows that the important feature of convertible preferred equity is not that it looks like debt on the downside (which is what the existing literature has focused on), but that there is automatic conversion in case of an IPO and not in an acquisition.").

[161] *See* Casimiro A. Nigro & Jörg R. Stahl, *Venture Capital-Backed Firms, Unavoidable Value-Destroying Trade Sales, and Fair Value Protections*, 22 EUR. BUS. ORG. L. REV. 39–86 (2021); Fried and Ganor, *supra* note 125 (discussing how the use of preferred stock may subject the holders of common stock to the venture capitalist's self-serving behavior).

shares and control after the liquidity event.[162] To retain and incentivize talented employees, the company can also offer them shares with restricted rights, gradually lifting such restrictions upon a pre-defined period and the completion of company milestones.[163] As with boards, the mandatory rules of corporate law delineating the content of shares' rights and the conditions for their exercise significantly constrain participants' ability to bargain the conditions to finance a business with high-risks and potentially high returns.

If a business is promising, founders and VCs will seek to circumvent legal rigidities through shareholders' agreements, which are essentially contracts between the shareholders of a corporation.[164] These agreements could be used as a complementary device to distribute cash-flow and control, regulating relationships among specific shareholders—e.g., holders of the same type of shares (preferred stock) or shareholders with similar priorities (founders)—or in specific situations, such as changes in corporate control.[165] Shareholders' agreements among *all* shareholders could also be functionally equivalent to the corporate charter, especially

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[162] Hellmann, *supra* note 162 ("Control shifts from the venture capitalist to the entrepreneur whenever the venture has sufficiently good prospects for going public."); Smith, *supra* note 160 ("[V]enture capitalists and entrepreneurs allocate control over portfolio companies through a combination of staged financing, voting rights, and contractual protections to ensure optimal allocation of decisionmaking authority while preserving the venture capitalists' exit options.").

[163] *See* Anat Alon-Beck, *Unicorn Stock Options—Golden Goose Or Trojan Horse*, 2019 COLUM. BUS. L. REV. 107–191 (2019) (discussing the widespread use of employee stock compensation in the tech sector); David R. Skeie, *Vesting and Control in Venture Capital Contracts*, No. 297 FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS 37 (2007) (analyzing the impact of time-contingent compensation on incentives in venture capital contracts).

[164] To be sure, they might simply register the company in a different jurisdiction, though such circumstances are outside of the scope of this analysis.

[165] In other words, "corporate law's statutory rules tie control to voting power, shareholder agreements allow the separation of voting and control." Rauterberg, *supra* note 31, at 3; *see also* Gilles Chemla, Michel A. Habib & Alexander Ljungqvist, *An Analysis of Shareholder Agreements*, 5 J. EUROPEAN ECON. ASS'N 93–121 (2007) (showing that shareholders' agreements allow participants to make specific ex ante investments, by restraining future renegotiation).

when corporate law constrains the corporation's ability to regulate the board and the shares through the charter. [166]

Because of the contractual nature of shareholders' agreements, it is frequently assumed that shareholders enjoy the freedom to stipulate a variety of corporate governance arrangements in them.[167] However, as with boards and shares, corporate law might explicitly ban agreements restricting or conditioning the exercise of a given right (e.g., voting), rendering agreements legally inexistent, null or void.[168] It could also deprive shareholders' agreements of enforceability, which means that signatories could potentially request damages for breach of contract (e.g., compensation for approving a merger against the agreement) but not use them to exercise control

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[166] *See* Fisch, *supra* note 31 (describing how shareholder agreements can be used to evade statutory limits on charter and bylaw provisions).

[167] *See* Steven N. Bulloch, *Shareholder Agreements in Closely Held Corporations: Is Sterilization an Issue*, 59 TEMP. L.Q. 61–82 (1986) (stating that shareholders' agreements "may contain whatever provisions the parties choose."). Such assumption prevails among scholars and practitioners, but not so much among judges. *See* Kulms, *supra* note 31 (finding, from a review of case-law in Germany and the United States, that "there is uncertainty about the shareholders' freedom of contract and the ground rules governing a contractual relationship between shareholders."). Two studies report similar findings in Russia and Hong Kong. *See* Suren Gomstian, *The Enforcement of Shareholder Agreements under English and Russian Law*, 7 J. COMP. L. 115–146 (2012) ("[Russian judicial practice] renders the provisions of shareholder agreements on buy-sell options and a [sic] default events invalid, and thus significantly limits the scope and effectiveness of shareholder agreements."); Rita Cheung, *Shareholders' Agreements: Shareholders' Contractual Freedom in Company Law* J. BUS. L. 504–05 (2012) ("[T]he Hong Kong judiciary displays a measure of hostility towards shareholder contracting around corporate norms.").

[168] The evolution of Colombian law offers an illustrative example. From 1995 until December of 2008, shareholders who also held a managerial position in the corporation could not be part of shareholders' agreements related to *voting*. Such agreements were legally inexistent. Because the law was silent on the legality of agreements signed by manager-shareholders in other topics, such agreements remained binding for the contractual parties only. *See* L. 222 Art. 70, diciembre 20, 1995, DIARIO OFICIAL [D.O.] No. 42.156 (Colom.); L. 1258 Art. 24, diciembre 5, 2008, DIARIO OFICIAL [D.O.] No. 47.194 (Colom.). For an analysis of this development, see Magda Liliana Camargo-Agudelo, *Los Pactos de Socios en el Derecho Colombiano*, 66 VNIVERSITAS 19–52 (2017).

(i.e., prevent the transaction),[169] a matter that has been astonishingly overlooked in the literature, notwithstanding their preponderance. When corporate law restricts their enforceability, shareholders' agreements cannot be used as a control-sharing device.

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[169] That is the case in Mexico, where the law explicitly recognizes shareholders' right to freely regulate the exercise of virtually all their rights in such agreements, but conditions their enforceability to a judicial decision. In practice, shareholders cannot invoke them to block a decision from the general meeting, unless a judge authorizes an injunction. *See* Decreto por el que se reforman, adicionan y derogan diversas disposiciones del Código de Comercio, artículo 2, Diario Oficial de la Federación [DOF] 13-06-2014 (Mex.), *modifying* Ley General de Sociedades Mercantiles [LGSM], artículo 198, Diario Oficial de la Federación [DOF] 04-08-1934, últimas reformas DOF 02-06-2009 (showing that "the shareholders of the corporations may agree among themselves" as to various regulations of the exercise of their rights, but such agreements "shall not be enforceable against the company, except in the case of judicial resolution.").

Figure 3: Unheeded Corporate Law Determinants of Startup Finance and Governance

	Concerns	Contractual Solutions	Corporate Law Determinants
Registration	● *Protection of business assets* ● *Protection of personal assets* ● *Distribution of cash-flow and control rights* ● *Exit options*	● *Founders' agreements* ● *Non-disclosure agreements* ● *Non-competition agreements*	● *Entity shielding* ● *Limited liability* ● *Share ownership* ● *Standard governance structure* ● *Access to stock markets*
Seed Finance	● *Protecting secrets* ● *Accessing finance*	● *Convertible-debt agreements* ● *Deferred share purchase agreements*	● *Requirements and costs for share issuances*
Venture Capital Finance	● *Incomplete contracting* ● *Moral hazard* ● *Agency costs*	● *Stock purchase agreements* ● *Shareholders' agreements*	● *Contingent voting and cash-flow rights* ● *Board composition* ● *Directors' duties*

Although the standard corporate form is almost indistinguishable across jurisdictions, the extent to which it can be customized varies. Even subtle differences could have a significant impact on startup founders' ability to reach trust-enhancing agreements with investors. Acknowledging these differences is vital to accurately examine the behavior and legal choices of relevant actors, specifically the prevalence of certain financial instruments, as detailed in the next section.

V. Startup Corporate Law: New Challenges and Opportunities

The preceding analysis revealed that differences in the regulation of the corporate form, boards, shares, and shareholders' agreements could significantly impact startups' ability to scale-up at different stages. Still, unlike listed firms, private corporations are subject to relatively stable rules that are scarcely scrutinized. By considering them individually, this section shows that regulatory choices and unnoticed reforms might already be influencing the emergence and finance of innovative firms worldwide and generating new enforcement challenges, as well as new research and policy opportunities.

A. Corporate Form

A vast literature has found that high costs to register an entity with limited liability can significantly hinder business formalization.[170] Likewise, the costs of registering and operating a *corporation* might force entrepreneurs to choose a different legal entity with weaker separation of assets and which is unsuited to plan a capital structure for the long haul. That seems to be the case in Switzerland, where high capital requirements induce entrepreneurs to initially choose an alternative entity, only to later convert and redesign the capital structure to receive external finance.[171]

Whether a corporation can operate with a single-member board and without an external auditor when it is not producing revenue can also facilitate founders' long-term capitalization plan for

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[170] *See supra* Section III.B.

[171] For a practitioners' discussion of the differences, *see* Michel Kertai & Barbara Nägeli, *GmbH or AG?*, EMBARK.LAW, embark.law/en/ag/ ("In Switzerland, founding an AG is costly – not least because AGs have a high minimum capital requirement of CHF 100k (50k need to be paid in at founding). It's easier to come up with the CHF 20k required to start a GmbH.").

business expansion and growth. There is increasing evidence of reforms reducing corporate registration and operation costs around the world,[172] but not on the impact that they might have on entrepreneurs' choices.[173]

To explore the impact of these reforms, it would be useful to compare the percentage of VC-backed startups adopting the corporate form in countries with divergent registration requirements and costs. To explore the impact of these reforms, it would be useful to compare the percentage of VC-backed startups adopting the corporate form in countries with divergent registration requirements and costs. For example, these costs encouraged Polish founders to avoid the corporate form[174] while they are less relevant for their American counterparts.[175] In jurisdictions where the corporate form is expensive, such as Switzerland,[176] it would be insightful to identify patterns in the valuation of startups that register as corporations against those that adopt other entity forms. This type of evidence can

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[172] *See, e.g.,* Pereira, *supra* note 50, at 434 (describing most of these reforms as following the "regulation of entry" approach adopted by the World Bank in 2003); McCahery, Vermeulen, & Priydershini, *supra* note 128 at 306–07 (finding that the expansion of "uncorporation," which means "business forms that combine the best of partnership and corporate law," in the United States and Europe "during the last two decades has been substantial," and that "this trend can be seen as a response to the dual demand for the reduction of regulation and improved legal vehicles that are better tailored to meet the needs of different types of firms).

[173] An exception is Pereira, *supra* note 50, at 435 ("This article focuses on one of the most radical company law-based tools to foster entrepreneurship . . . .").

[174] Poland recently approved a legal reform creating a simplified corporation, precisely to tackle this problem. *See* Jakub Jasinski, *Poland Authorizes a New Type of Corporate Entity: The "Simple Joint Stock Company,"* THE NAT'L L. REV. (2021), natlawreview.com/article/poland-authorizes-new-type-corporate-entity-simple-joint-stock-company (last visited Feb 18, 2022).

[175] In fact, American founders are even willing to sacrifice tax savings, so long as they can establish an appropriate capital structure. *See* Bankman, *supra* note 108 (discussing how the advantages of the U.S. corporate forum include the minimized legal and organizational costs).

[176] *See* Kertai & Nägeli, GmbH or AG?, supra note 191.

contribute to accurately assessing the relevance of costs for fast-growing startups (and not for entrepreneurship, in general).

Where reforms have already taken place, new challenges might emerge. Immediately apparent is the protection of creditors. The corporate form provides the strongest separation of personal from business assets, and, hence, the claims of an individual's creditors are automatically subordinated (i.e., without consent) when said individual becomes a shareholder.[177] Reduced regulatory costs facilitate the use of the corporation to disenfranchise personal creditors and increase the cost of debtor opportunism.[178] These developments offer an opportunity to revise bankruptcy standards for personal and corporate debtors, and to advance a renewed approach to the circumstances that merit lifting or piercing the corporate veil, which would benefit from comparative analyses.

B. Boards

Corporate boards are undeniably relevant instruments for the distribution of control rights, reducing agency costs for investors and correspondingly facilitating access to external finance.[179] In fact, there is evidence that VCs exercise their control rights, replacing management at decisive stages and supporting business growth.[180]

[177201] *See, e.g., Chapter 11-Bankruptcy Basics*, United States Courts, uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics (last visited Oct. 13, 2022) (discussing how the chapter 11 bankruptcy case of a corporation (corporation as debtor) does not put the personal assets of the stockholders at risk other than the value of their investment in the company's stock).

[178] Hansmann et al., *supra* note 78 (describing benefits of entity shielding); *see also* Richard M. Buxbaum, *Commercial Law - Single Shareholder Company U.S. Law in an Era of Democratization: Section III*, 38 AM. J. COMP. L. SUPP. 251–270 (1990) (discussing how these and related issues are exacerbated in single-shareholder corporations).

[179] For a review of empirical studies in multiple jurisdictions, see Jonas Gabrielsson & Morten Huse, *The Venture Capitalist and the Board of Directors in SMEs: Roles and Processes*, 4 VENTURE CAP.: INT'L J. ENTREPRENEURIAL FIN. 125, 135 (2002).

[180] Hellmann & Puri, *supra* note 33, at 182 ("Kaplan and Stromberg (2000a) provide empirical evidence from venture capital contracts indicating that a significant number of control rights are allocated to the venture capitalists."); *see also* Thomas Hellmann & Manju Puri, *The Interaction*

Besides monitoring management, rules on election, composition and powers also frame bargains. To an extent, this was the case in Italy before 2005.[181]

Expanding the ability to structure and empower the board could enhance startup finance. Mexico introduced a new corporate form with expanded freedom for shareholders to empower the board, which appears to have attracted many Latin American startups raising VC finance.[182] In fact, by January 2022, Mexico had seven

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Between Product Market and Financing Strategy: The Role of Venture Capital, 13 REV. FIN. STUD. 26 (2000) (describing how venture capitalists contribute to management professionalization); Vance H. Fried, Garry D. Bruton & Robert D. Hisrich, *Strategy and the board of directors in venture capital-backed firms*, 13 J. BUS. VENTURING 493–503 (1998) (finding, from interviews with 383 US venture capitalists, "that boards of directors in venture-capital backed companies are more involved in both strategy formation and evaluation."); Gerard George, Johan Wiklund & Shaker A. Zahra, *Ownership and the Internationalization of Small Firms*, 31 J. MGMT. 210–233 (2005) (finding, with data from 889 Swedish private companies, that directors appointed by investors are more supportive of expansion and internationalization strategies).

[181] *See* Guido Ferrarini, Paolo Giudici & Mario Stella Richter, *Company Law Reform in Italy: Real Progress?*, 4 RABEL J. COMPAR. AND INT'L PRIV. L. 658, 677 (2005) ("The Italian model is characterized by a board of directors that carries out management and supervisory functions, while the collegio sindacale monitors both."); Paolo Giudici & Peter Agstner, *Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?)*, 20 EUROPEAN BUS. ORG. L. REV. 597, 579 ("In response to competitive pressure, economic aspirations and social changes, and to general demands from European institutions for some forms of facilitation of firm creation and venture capital, the Italian lawmaker has slowly transformed the SRL and created what is basically a new type of company (the SME SRL), which lies in between the two original types but whose borders are not fully clear.").

[182] *See* Pereira, *supra* note 50 (discussing new legal forms introduced to Latin American countries, such as "simplified corporations" ("SC"), introduced to Chile and Columbia to foster entrepreneurship); *see also* Pieter Wasung, *Mexico Is Trending - SAPIS: A Tailor-Made Solution For Investors* (Mar. 20, 2017) mondaq.com/unitedstates/International-Law/578028/Mexico-Is-Trending--SAPIS-A-Tailor-Made-Solution-For-Investors ("SAPIS only require 10% of the capital stock to (i) summon a shareholders meeting; (ii) to name a comisario; and (iii) to name a Director of the Board. Only 15% of the capital stock is needed to file a civil suit against company administrators,

unicorns, and a growing number of startups on the verge of becoming one.[183]

However, many reforms relaxing the regulation of boards also include other changes. To understand their benefits and perils it is first necessary to distinguish the type of amendments. Flexible regulation of board election is associated with staggered boards, which are used to dissuade hostile takeovers in public corporations.[184] While this flexibility may grant founders additional protection and bargaining power, it may also enable direct representation of a class of shareholders in the board, which can disproportionately constraint others, such as holders of common shares or employees with restricted shares.[185] Expanded board powers to issue preferred stock and negotiate the privileges without shareholder approval (i.e., blank check) could also be abused to lawfully dilute insufficiently protected shareholders.[186] With clearer understanding of the type of reform it

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and 20% of the capital stock is needed to contest a resolution of the board, which again is lower than the minimum requirements for S.A.'s.").

[183] *The Complete List of Latin American Unicorns [Updated 2022]*, CONTXTO (2022), contxto.com/en/news/the-latin-american-unicorns-galloping-to-success/ (last visited Feb 19, 2022) ("Mexico made its debut as a unicorn maker . . . . It had zero unicorns in January, but by December seven companies had taken this title.").

[184] Lucian Arye Bebchuk, John C. Coates IV, & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants Response*, 55 STAN. L. REV. 885, 885–917 (2002) ("We have demonstrated in our original paper that the post-just say no effective staggered board has severely reduced the pressure that the market for corporate control can exert on disloyal boards.").

[185] These circumstances would further increase the complexity of the issues discussed by Sepe, *supra* note 28, at 312 ("A constituency director is a director appointed to a board specifically to advance the interest of a certain constituency (the 'sponsor' or the 'designating investor').").

[186] For a discussion on blank check preferred stock, see JOSEPH W. BARTLETT, FUNDAMENTALS OF VENTURE CAPITAL 45 (1999) (observing that such provisions allow the board to negotiate with investors and establish the detailed privileges when issuance of stock is needed); *see also* EDWIN L. MILLER JR., LIFECYCLE OF A TECHNOLOGY COMPANY: STEP-BY-STEP LEGAL BACKGROUND AND PRACTICAL GUIDE FROM STARTUP TO SALE 21 (2008) ("Although blank check preferred stock can be very useful . . . its convenience has become diluted by the increasing prevalence of veto and

would be possible to examine how participants are using new prerogatives. For example, whether powerful boards are indeed facilitating new rounds of finance (e.g., negotiating privileges and issuing new preferred stock) and whether VCs or founders are reserving board seats. Empirically, this could be accomplished by reviewing information disclosed by companies during the listing process,[187] through interviews with members of VC associations and incubators, or through surveys.[188]

Unnoticed reforms might already be creating new legal issues, making these seemingly technical questions a matter of relevance for policymakers, judges, and practitioners. A potential challenge arising from expanded freedom to define the board composition is whether a specific class of shareholders (e.g., Series A) can elect its own board member and, if so, how to evaluate the conduct of that director. Standard corporate fiduciary duties require directors to act in the interest of the company and its shareholders, not of specific investors.[189] While this maxim clearly indicates that board class representation is an improper means to exercise control, a matter recently confirmed by the Delaware Chancery Court,[190] it remains highly valued by VCs and thus it is an area prone to changes.[191]

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other approval rights that prevent later rounds of financing without the approval of existing investors, irrespective of the existence of blank check preferred stock.").

[187] *See, e.g.*, Rauterberg, *supra* note 31, at 1149 (analyzing IPO disclosures for information regarding shareholder agreements).

[188] *See, e.g.*, Hellmann & Puri, *supra* note 33, at 174 (discussing evidence collected from "interviews, surveys, and commercial databases. . .").

[189] Martin Gelter & Geneviève Helleringer, *Constituency Directors and Corporate Fiduciary Duties*, *in* PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 302, 302–20 (Andrew S. Gold & Paul B. Miller eds., 2014) (discussing how although some corporations allow certain shareholders to appoint directors to represent their interests, these directors still have a duty act in the interest of the company, as a whole, and not in the interests of the investors who helped place them in their position).

[190] *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 41 (Del. Ch. 2013) (holding that it is the duty of directors to pursue the interests of the company and common stockholders over the interests of preferred stockholders).

[191] *See* Pollman, *supra* note 35, at 179–180 ("VCs seek board seats as part of their investment—for access to information, to monitor against opportunistic behavior, for voice or control on important decisions such as

C. Shares

It has been documented that seed and VC finance heavily relies on the possibility of issuing different classes of shares.[192] That practice allows investors to exercise control, without acquiring the majority of the equity. Yet, there is not enough evidence on how corporate law might frame contractual arrangements in this regard. Differences in the rules governing share issuances and transfers, restrictions to common (required for performance-based compensation agreements with founders and employees), and privileges to preferred (discussed above) directly influence the bargains between founders and investors.

In Germany, the transfer of shares requires involvement of a notary, which has a deterring effect in the use of convertible debt and venture finance (at least in early stages), and fostered the development of contractual strategies that resemble equity finance.[193] In Japan, the costs of "sweat equity" deterred founders from expanding and decelerated the growth of the VC industry.[194] In

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future financings or exit, and to add value to the company."); Bratton & Wachter, *supra* note 174, at 1875 ("The controlling venture capitalist poses a new question for the law of preferred stock: Does fiduciary law come to bear to protect a common stock minority when a preferred stockholder in control exercises its contract rights to impair the common's interest?"); Sarath Sanga & Eric L. Talley, *Don't Go Chasing Waterfalls: Fiduciary Duties in Venture Capital Backed Startups*, (European Corp. Governance Inst., Working Paper No. 634/2022, 2022), papers.ssrn.com/sol3/papers.cfm?abstract_id=3721814 (describing how inefficiencies created by *Trados* affect VC-backed firms).

[192] Da Rin, Hellman, & Puri, *supra* note 97 (elaborating on the purpose of different types of shares).

[193] *Id.* at 10 (examining the role of VC investors in German corporate governance). In Switzerland, transferring shares of limited liability companies (GmBH) is also costly, but there is no empirical evidence that it has fostered the creation of contractual "replicas," but rather an indication that businesses are forced to transform into corporations (AG) to access VC finance. *See* Kertai & Nägeli, *supra* note 191 (examining the effects on startups that chose to either be an AG or a GmbH).

[194] *See* Shishido, *supra* note 10 (expounding on the effects of Japanese corporate law policy on startup outcomes).

China, lack of convertible-preferred led to the development of a trust-constraining financial agreement, the "valuation adjustment mechanism" or VAM, which limits founders' ability to reclaim control after investors exit.[195]

There seems to be a trend towards relaxing the regulation of shares in private firms,[196] although their apparent heterogeneity calls for further scrutiny. A comparative analysis of the procedural requirements for new issuances, flexibility to restrict common, and expansion of privileges assignable to preferred appears indispensable to understand VCs behavior more accurately and, correspondingly, the extent to which legal reform can enhance startups access to external finance. A "Leximetrics"[197] examination on the evolution of the regulation of shares would offer a quantitative basis to examine the extent to which relevant reforms might have influenced the type and volume of deals in different jurisdictions. For example, in a similar fashion that the CBR Leximetrics Datasets[198] informed studies on stock market development.[199]

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[195] Lin Lin, *Contractual Innovation in China's Venture Capital Market*, 21 EUR. BUS. ORG. L. REV. 101–138 (2020) (examining the role of modern corporate law developments in Chinese startup outcomes).

[196] *See*, *e,g.,* Pereira, *supra* note 50; Giudici and Agstner, *supra* note 204 (proposing that developments in Delaware corporate law are influencing corporate law in Eurpoe); Shishido, *supra* note 10 (comparing developments in Japanese corporate law to that in other venues, including Delaware).

[197] The term "leximetrics" was introduced by Robert Cooter & Thomas Ginsburg to conduct "comparative quantitative analysis of legal instruments," and has been used extensively in quantitative studies of corporate law, among others. *See* Robert D. Cooter & Tom Ginsburg, *Leximetrics: Why the Same Laws are Longer in Some Countries than Others*, AM. L. & ECON. ASS'N ANN. MEETINGS (2004); Mathias M. Siems, *Taxonomies and Leximetrics*, *in* THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 228–250 (2018) (analyzing the leximetrics of corporate law in the U.S.).

[198] The CBR Leximetrics Datasets cover changes in the laws governing labor relations, and both shareholder and creditor protection in several countries over various years. *See* John Armour, Simon Deakin & Mathias Siems, *CBR Leximetric Datasets [Dataset]*, (2006), doi.org/10.17863/CAM.506.

[199] Simon Deakin, Prabirjit Sarkar, & Mathias Siems, *Is There a Relationship Between Shareholder Protection and Stock Market Development?*, 3 J.L. FIN. AND ACCT. 115–146 (2018) (studying the effects of different corporate governance arrangements on stock market

Identifying differences and similarities among unnoticed reforms would contribute to developing solutions to emerging challenges. For example, enhanced freedom to regulate shares supports imbalances in shareholder rights and the possibility of unfair outcomes.[200] Extreme examples are unavoidable trade sales. These might occur when VCs use their privileges to force the sale of the company in a disadvantageous manner to common shareholders.[201] This might happen when the VC fund is close to its termination period and it is impossible to sale the company at a price allowing common shareholders to participate in the gains (e.g., due to market conditions or because the company is not performing as well). These and similar scenarios challenge core features of corporate law, such as fiduciary duties, requiring clear rules on shareholders' ability to accept unfair outcomes ex ante. While recent studies have devised solutions for these challenges in some jurisdictions,[202] the extent to which they can be transplanted to others or inform variations would depend on a clear understanding of these changes.

D. Shareholders' Agreements

Shareholders' agreements are one of the most obscure areas of corporate law, particularly in comparative perspective. To the extent that they can be complements or substitutes to charter or bylaws in jurisdictions with rigid regulation of boards and shares, much clarity is required.

From a conservative perspective, shareholders' agreements are contracts that only bind their signatories, and thus corporate officers and directors are not obliged to observe or follow them when counting shareholders' votes.[203] Shareholders could even be liable if

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development); Armour et al., *supra* note 103 (examining how stock markets historically developed under the contractarian formulation).

[200] *See*, *e.g.*, Bartlett & Talley, *supra* note 29 (explaining the myriad of effects of different shareholder voting rights schemes on firm outcomes).
[201] For an analysis, see Nigro and Stahl, *supra* note 179.
[202] *E.g.*, Sanga & Talley, *supra* note 217, at 38–39. (Proposing "a rule that obligates [a company's] board to prioritize preferred shareholders' interest and to treat common shareholders as contractual claimants.").
[203] In some jurisdictions, it is explicitly stated in law, as in Portugal. *See* Código das Sociedades Comerciais [Business Associations Code], art. 17.

they depart from what is mandated by corporate law and the corporation's constitutive documents.[204] To clarify this issue, some jurisdictions have explicitly recognized shareholders' agreements and established formalities to ensure that they are observed and respected,[205] incentivizing their use.

Agreements among all shareholders are also a common and seemingly safer strategy to circumvent statutory restrictions to the distribution of cash flow and control rights in charter or bylaws.[206] The success of this strategy, however, depends on whether the law is more tolerable to such agreements, as seems to be the case in the United Kingdom,[207] or whether there is an explicit restriction, such as to regulate anti-dilution protections, as happens in India.[208] Signatories can still evade these restrictions by establishing pecuniary clauses with liquidated damages[209] and an arbitration clause.[210] These strategies deprive judges and policymakers from the opportunity to evaluate and influence (for better or worse) startups' governance.

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[204] *See* Kulms, *supra* note 31.

[205] For example*,* Colombia (L. 1258/2008 art. 24, diciembre 5, 2008, DIARIO OFICIAL [D.O.]), the Netherlands (Art. 2:242 BW); and Russia (Federal'nyĭ Zakon RF ob Aktsionernykh Obshchestvakh [Federal Law of the Russian Federation on Joint Stock Companies], Sobranie Zakonodatel'stva Rossiĭskoĭ Federatsii [SZ RF] [Russian Federation Collection of Legislation], 1995, No. 208-FZ, Art. 32.1). In France, recent case law also indicates that the corporate constitutive document can give shareholder agreements its same binding authority. *See* Cour de Cassation [Cass.] [supreme court for judicial matters] com., June 27, 2018, No. 16-14097).

[206] Kulms, *supra* note 31, at 264 ("Today, shareholder agreements restricting the transferability of stock are quite common.").

[207] *See* Companies Act 2006, c. 46, §§ 17, 29, 33 (UK), legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf ("This chapter applies to . . . any resolution or agreement agreed to by all members of a company . . . .").

[208] Jidesh Kumar & Richa Mehra, *Beware Rights of Shareholders M&A: Indian Private Equity*, 25 INT'L FIN. L. REV. 40, 40–41 (2006) (discussing limitations on the enforceability of anti-dilution provisions in India).

[209] Fleischer, *supra* note 7, at 692 ("Breaches of shareholder agreements are almost universally subject to liability sanctions. However, these are unlikely to be an appropriate remedy due to the difficulties in proving the damages incurred. As a result, practitioners across the board recommend liquidated damages clauses as an indirect enforcement mechanism.").

[210] *See* MADELON & THOMSEN, *supra* note 31, at 930–31 ("Shareholder agreements may . . . select arbitration in lieu of litigation.").

The NVCA, BVCA, and LAVCA encourage shareholders' agreements,[211] which suggests that they are widely used in VC deals, despite the lack of doctrinal depth. Recent evidence demonstrates that fifteen percent of corporations that go public in the United States use shareholders' agreements to distribute control in a variety of ways, including restrictions to share transferability, vote election and even directors' duties.[212] It is a strong indication of the relevance of these types of agreements, considering that only a small fraction of firms access the US stock market, [213] and that the US has one of the most flexible regulations of non-listed firms.

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[211] NVCA, *Model Legal Documents*, *supra* note 107; BVCA, *Model Documents for Early Stage Investments*, *supra* note 107; LAVCA, *Guide to Venture Capital and Private Equity Term Sheets - Argentina*, LAT. AM. VENTURE CAP. ASS'N (2017).
[212] *See* Rauterberg, *supra* note 31.
[213] *See* David R. Francis, *Changing Business Volatility*, NBER, nber.org/digest/apr07/changing-business-volatility (last visited Sep. 23, 2022) (publicly traded companies constitute less than 1 percent of all U.S. firms).

A comparative examination of the use (and potential abuse) of shareholder agreements in the context of startup finance is exceptionally difficult, given the confidentiality and secrecy that has halted doctrinal developments in this field across jurisdictions. To overcome these challenges, a "case-based quantitative analysis"[214] of the most pressing issues would be particularly insightful, not only offer guidance for industry participants and judges, but also an opportunity to redesign corporate law. Emerging issues include the extent to which they can be used to waive fiduciary duties[215] and whether issues deriving from them might be arbitrable.[216]

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[214] Generally, this method enables the identification of differences between jurisdictions by documenting how legal experts in each of them would solve the same legal issue. For an overview, see David Cabrelli & Mathias Siems, *Convergence, Legal Origins, and Transplants in Comparative Corporate Law: A Case-Based and Quantitative Analysis*, 63 AM. J. COMP. L. 109–153 (2015).

[215] Fisch, *supra* note 31.

[216] Hilmar Raeschke-Kessler, *Objective Arbitrability of Corporate Disputes – the German Perspective*, 3 EUR. BUS. ORG. L. REV. 553, 553–567 (2002); MADELON AND THOMSEN, *supra* note 31.

Figure 4: Startup Corporate Law

	Trust-Enhancing Aptitude	**Overlooked Reforms**	**Opportunities/ Challenges**
Corporate Form	● *Entity shielding* ● *Limited liability* ● *Equity finance* ● *Access to stock markets* ● *Standardized governance* ● *Judicial predictability*	● *Registration costs* ● *Operation costs*	● *Inexpensive access to strong limited liability and entity shielding* ● *Creditor protection and cost of credit*
Boards	● *Standard governance structure*	● *Composition* ● *Powers* ● *Liability*	● *Contingent control* ● *Duties of constituency directors*
Shares	● *Voting rights as control* ● *Cash-flow rights as incentives*	● *Issuances* ● *Range of restrictions and preferences of different classes of shares*	● *Contingent control and cash-flow* ● *Enforceability of preferred rights*
Shareholder Agreements	● *Strengthen cash-flow and control rights* ● *Circumvent legal restrictions to governance*	● *Waiver of fiduciary duties* ● *Arbitration*	● *High contractual freedom and innovation* ● *Opaque governance* ● *Lack of development*

	and financial arrangements	*in corporate law*

VI. Implications

A. For Comparative Corporate Law and Governance

The forgoing investigation has two general implications for corporate law and governance. First, it confirms that the traditional characterization of private firms as "family-owned" and "local" must be discarded. Non-listed companies are heterogeneous and many of them have the potential to transform entire economies around the world.[217] The increasing economic and social significance of startup companies, as well as the identified changes in ownership structures across jurisdictions, discredits the apparent irrelevance of corporate law for these private businesses, which prevailed in corporate law studies, both domestic and comparative.[218] These changes also confirm the need to discontinue the use of business registration requirements as a proxy of legal systems' aptitude to promote entrepreneurship, which has proven to be of limited service to both corporate and comparative law.[219] Beyond providing standard-terms and facilitating the organization of small business enterprises, corporate law can influence how innovations are crafted and financed, offering a renewed purpose for the comparative study of the regulation of non-listed firms.

The second implication of the analyses is the need to develop a trusted framework for comparative legal analysis. *Legal* rules conditioning bargains among startups' founders and financiers vary substantially across jurisdictions and are unaccounted for by the comparative corporate law scholarship.[220] The systematic comparison of the evolution of such rules will contribute to explaining how the regulation of non-listed firms influences the development of startup and venture capital ecosystems, and, relatedly, how it may foster capital market development and economic growth. Comparative experiences, properly assessed, may also inform the solution of emerging issues. VC-oriented corporate

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[217] For concrete examples, see Section II.
[218] *See supra* Section III.B.
[219] *Id.*
[220] *See supra* Section V.

law reforms are proliferating and likely generating new problems for startups and other non-listed companies worldwide without being adequately addressed.[221] Higher risks for third parties, changing fiduciary duties for specific board members, and ex-ante agreements on unfair transactions are just a few of the problems.[222]

While simply a *minimum viable product*, the framework introduced in this essay highlights several benefits of a systematic comparison of legal rules governing non-listed corporations, their boards, shares, and shareholder agreements—i.e., *startup corporate law* ("SCL"). For example, unobserved legal rules governing shares issuances and rights may explain the prevalence of certain securities in some countries and the use of shareholder agreements as complements or substitutes of corporate charters and bylaws. Overall, a systematic comparison of all these rules will be instrumental in assessing—beyond Delaware case law and commentary—the extent to which the evolution of SCL is contributing to expanding the pool of innovative firms capable of scaling up fast and whether it might be creating new legal issues—i.e., the merits and perils of corporate law reforms.

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[221] Some of those problems have been recently discussed in U.S. legal scholarship but not comparatively. *See, e.g.,* Pollman, *supra* note 35, at 155 (showing "that venture-backed startups involve heterogenous shareholders in overlapping governance roles that give rise to vertical and horizontal tensions between founders, investors, executives, and employees."); *and* Bartlett & Talley, *supra* note 29, at 178 (concluding that ". . . economists and other social scientists interested in understanding and/or reforming corporate governance cannot afford to ignore or assume away the legal and regulatory structures that provide its foundation.").

[222] *See* Sanga & Talley, *supra* note 217, at 2 ("Problems can (and inevitably do) arise when strategic business decisions also implicate these rights, pitting preferred shareholders against common. In such settings, the board of directors must decide how to honor the special rights of preferred shareholders while discharging its own fiduciary obligations."); Amy Deen Westbrook, *We('re) Working on Corporate Governance: Stakeholder Vulnerability in Unicorn Companies*, 23 U. PA. J. BUS. L. 505, 573 (2020) ("As the number of unicorns continues to swell, and their impacts are felt by more stakeholders, the need for sound corporate governance may rouse lawmakers to act."); Matthew Wansley, *Taming Unicorns*, 97 IND. L.J. 1203, 1203 (2021) ("Some of these unicorns committed misconduct that they successfully concealed for years. The difficulty of trading private company securities facilitates the concealment of misconduct.").

B. For Venture Finance

The analysis also has implications for the study of venture finance or financial contracting. First and foremost, it reveals that corporate legal rules can influence startup finance.[223] Corporate law might, for example, proscribe boards' ability to issue new preferred shares or pre-define the rights that might be assigned to them, constraining parties' bargaining powers.[224] Hence, contrary to prevailing accounts in the financial contracting literature,[225] investment contracts are insufficient to understand how investors and founders distribute cash flow and control rights across jurisdictions at various stages.[226] SCL may, thus, assist the cross-border examination of venture deals, by providing an accurate representation of the legal system against which to assess founders and investors behavior.

The study also offers a cautionary warning against the widespread use of different indexes and rankings for the empirical examination of the legal determinants of private firms' governance and access to external finance.[227] Investor protection indexes, for example, are based on the regulation of public companies, which vary in content and scope.[228] Rankings on legal systems' efficiency in

[223] *See generally supra* Section IV (detailing how legal rules affect startup companies during each stage of their life cycle).
[224] *See supra* Section V.B.
[225] *See supra* section III.C.
[226] To be sure, lawyers will almost always find a way to adapt a standard financial arrangement to local rules as means to ensure enforceability; however, the selection of a specific instrument (e.g., charter, shareholders' agreements) and the specific provisions will likely be a reaction to the structure of corporate law and not evidence of the interests of the parties.
[227] *See* Da Rin, Hellmann, & Puri, *supra* note 97 (outlining the main research strategies to investigate the determinants of venture finance, evidencing a widespread reliance on broad legal indexes).

[228] For a critical overview of these indexes, see Spamann, *supra* note 103 (discussing how use of "less refined" data-collection methods have led legal scholars to claim "that values from LLSC (1998) for certain countries are inaccurate, based on the scholars' knowledge of those countries' laws"), Priya P. Lele & Mathias M. Siems, *Shareholder Protection: A Leximetric Approach*, 7 J. CORP. L. STUD. 17, 17–50 (2007) (identifying various shortcomings of the 1998 Law and Finance article, including "a very limited

enforcing contracts and ease of registering a business also offer narrow (and even inaccurate) representations of a legal system's ability to support the emergence of fast-growing innovative firms, as they fail to account for the key legal determinants of startups' governance and finance identified above.[229]

C. For Public Policy

Finally, there are two main policy implications of the preceding analyses. First, it is pivotal to acknowledge the business, legal and financial idiosyncrasies that distinguish startups from other types of businesses.[230] Broad policies aimed at fostering entrepreneurship through company law reform often place excessive emphasis on procedural aspects (e.g., business registration requirements),[231] with little regard to the rules that govern bargains between founders and investors (e.g., voting rights).[232] Policies aimed at incentivizing VC investments often focus on investors (e.g., tax benefits), which may indeed increase the capital available for startups, but not necessarily remove barriers to trust-enhancing agreements between startups and founders that frustrate the development of transformative businesses.[233] Moreover, these reforms often overlook the fact that many startups can successfully develop innovative products or services without VC investments (e.g., going from seed to a merger), but could still benefit from a legal system that facilitates bargains with financiers.[234]

A second policy implication is that the rules integrating SCL should be considered when designing broader capital markets

number of variables" that "suffer[] from a US bias" and are "too broad or vague"), and Section II.C.

[229] *See supra* Section IV.
[230] *See supra* Section I.
[231] *See supra* Section III.B; Djankov et al., *supra* note 6 (advancing the theory that registration requirements the limit rate of new business registration); Pereira *supra* note 50 (uncovering the limitations of such approach).
[232] *See supra* Section IV.
[233] *See supra* Section V.
[234] *See generally* Alex Lazarow, *Beyond Silicon Valley: When Startups Succeed in Unlikely Places*, HARV. BUS. REV., Mar.-Apr. 2020 (chronicling growth strategies of startups outside traditional venture capital markets).

policies, such as changes in listing requirements or securities regulations. To the extent that SCL can influence the range and characteristics of companies that can be acquired by listed firms or that can reach the stock market, a comparative examination of these rules is pivotal for the soundness of such policies. Many reforms across jurisdictions are already aiming to improve startups' prospective listings and acquisitions, highlighting the urgency of adopting a comparative approach as the one proposed here.

VII. Conclusion

Startup companies are prospective large competitive companies in their early stages. By combining fast development of scalable products with rapid expansion, they are expected to accelerate the pace of innovation and increase competition in the market. This idiosyncratic approach requires continuous influx of high-risk capital, which traditional lenders are unable to supply. Financing startups, therefore, requires founders and financiers to resolve their mutual distrust—the former agreeing to disclose secrets and share control, and the latter committing to supply capital without acquiring a controlling interest. Startup participants enhance trust through strategic distributions of the company's cash-flow and decision-making rights. In this paper, I showed that startup finance is fenced by corporate laws that delineate such distributions. Specifically, it is fenced by the legal rules governing boards, shares, and shareholders' agreements in non-listed corporations, which are in the blind spot of comparative and empirical studies. I refer to these rules as *Startup Corporate Law* or SCL and identify several opportunities that can emerge from their study.

SCL might explain cross-country differences in the number of fast-growing startups, their ability to raise funds, and the prevalence of specific financial instruments. For example, the high costs of issuing shares in Germany are associated with comparatively higher levels of non-equity crowdfunding, while mandatory rules on shares' rights in China led to the development and standardization of a trust-constraining financial agreement. Within a given jurisdiction, under-scrutinized reforms on selective rules might also explain changes. For instance, Mexico's early-2000s reform expanding the ability to empower the board of private corporations appears to have increased the number of VC-backed startups, which has attracted companies from other Latin American countries. SCL is therefore crucial to better understand the determinants of startup finance and how the law can be used to achieve specific outcomes.

The evolution of SCL might also be generating new enforcement challenges that justify further scrutiny. Reduced costs of registering and operating a non-listed corporation facilitate founders' access to strong asset protection and the ability to design a projected capital structure to accommodate investors in different stages, but it might also increase creditors' monitoring costs and, correspondingly, the cost of debt finance. Flexible rules on board election, composition, and powers enable trust-enhancing distributions of control, but they appear to allow direct board representation to some shareholders (*i.e.*, constituency directors), which might be at odds with the standard fiduciary duties owed to shareholders as a whole. Similarly, expanded freedoms to create and regulate different classes of shares can be used to both incentivize and retain founders and employees, and to protect investors; but they also propitiate unfair distributions of rights among shareholders. Shareholders' agreements are likely used as substitutes and complements of these and other governance arrangements that are uniquely related to startup finance and might challenge established practices and doctrines in corporate law. A comparative analysis of these developments is therefore crucial to provide insights to policymakers, judges, and arbitrators, who will soon confront ever-complex issues in non-listed corporations worldwide.

Despite its increasing relevance, changes to SCL are hidden in plain sight, either englobed in broader legal reforms that selectively touch upon some of its elements, or in technical judicial decisions or binding administrative acts reshaping the interpretation of legal standards. Accordingly, a new framework for the comparative analysis of corporate law determinants of startup finance is required. Borrowing startup jargon, the analyses and framework introduced in this paper constitute a *minimum viable product* to account for the legal rules framing the distributions of cash-flow and control rights in non-listed corporations' boards, shares, and shareholders' agreements.