Venture Capital Contracting as Bargaining in the Shadow of Corporate Law Constraints

Law Working Paper N° 833/2025
March 2025

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Abstract

Venture capital ("VC") has built a solid reputation for spurring innovation and economic growth, thus emerging as a crown jewel of the U.S. economy since the 1980s. The development of the U.S. VC market has benefited from the enabling nature of U.S. (Delaware) corporate law, which allows parties to devise a complex contractual framework that economists consider the best real-world solution to the market frictions bedeviling the finance of high-tech innovative projects. The law and finance literature has paid attention to corporate law as one of the determinants of VC investments by examining how variations in shareholder protection shape VC contracting. It has underscored the importance of flexible corporate law to enable the tailor-made arrangements that define VC-backed firms' unique governance structure. Vice versa, it has also documented anecdotally how mandatory corporate laws can impede the adoption and use of some specific components of the U.S. contractual framework. This article contributes to this literature, first, by conceptualizing, in a general theoretical framework, the role that flexible or rigid corporate law in action plays in supporting or hindering VC. Second, it identifies the channels through which mandatory corporate law constrains VC contracting. Third, it documents the real-world significance of these phenomena by illustrating how the constraints stemming from the corporate law regimes in force in two European jurisdictions, namely Germany and Italy, impact the transplant of the contractual framework governing VC deals in the U.S.

Keywords: Comparative Corporate Law, Comparative Corporate Governance, Entrepreneurship, Financial Contracting, Private ordering, Start-ups, Venture Capital

JEL Classifications: G38, K22, L26

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*Venture capital (“*VC*”) has built a solid reputation for spurring innovation and economic growth, thus emerging as a crown jewel of the U.S. economy since the 1980s. The development of the U.S. VC market has benefited from the enabling nature of U.S. (Delaware) corporate law, which allows parties to devise a complex contractual framework that economists consider the best real-world solution to the market frictions bedeviling the finance of high-tech innovative projects.*

The law and finance literature has paid attention to corporate law as one of the determinants of VC investments by examining how variations in shareholder protection shape VC contracting. It has underscored the importance of flexible corporate law to enable the tailor-made arrangements that define VC-backed firms' unique governance structure. Vice versa, it has also documented anecdotally how mandatory corporate laws can impede the adoption and use of some specific components of the U.S. contractual framework.

This article contributes to this literature, first, by conceptualizing, in a general theoretical framework, the role that flexible or rigid corporate law in action plays in supporting or hindering VC. Second, it identifies the channels through which mandatory corporate law constrains VC contracting. Third, it documents the real-world significance of these phenomena by illustrating how the constraints stemming from the corporate law regimes in force in two European jurisdictions, namely Germany and Italy, impact the transplant of the contractual framework governing VC deals in the U.S.

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CONTENTS

I. INTRODUCTION

Venture capital ("VC") has been associated with an increase in innovation, employment, and growth ever since its exponential expansion in the 1980s.[1] A vibrant VC market has been a key component of the financial infrastructure that boosted innovation in the U.S.[2]

The literature has investigated the informal and formal determinants of VC investments.[3] Some studies have focused on corporate law and, more specifically, on how its quality, measured primarily with proxies for investor and creditor protection, may facilitate the emergence of a vibrant VC ecosystem.[4] Other studies have pointed to the importance of corporate law's rigidity or flexibility as a determinant of VC activity.[5] Theses analyses could

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[1] The early-1980s' sharp increase in VC activity in the U.S. was associated with a significantly higher patenting rate: while the *ratio* of VC to R&D averaged less than 3% from 1983 to 1992, VC accounted for 8% of industrial innovation in the same period. Samuel Kortum & Josh Lerner, *Assessing the Contribution of Venture Capital to Innovation*, 31 RAND J. ECON. 674 (2000). VC-backed firms have led to an increase in employment in around the same period. Sampsa Samila & Olav Sorenson, *Venture Capital, Entrepreneurship, and Economic Growth*, 93 REV. ECON. & STAT. 338 (2009). VC has ultimately fueled massive economic growth nationally. Sophie Manigart & Harry Sapienza, *Venture Capital and Growth*, *in* THE BLACKWELL HANDBOOK OF ENTREPRENEURSHIP 240 (Donald L. Sexton & Hans Landström eds., 2000).

[2] See, e.g., Martin Kenney, *How Venture Capital Became a Component of the US National System of Innovation*, 20 IND. & CORP. CHANGE 1677 (2011) (using the evolution of the U.S. VC industry as a case study to illustrate how so-called national systems of innovation evolve over time and add new institutions, such as VC, to better support the quest for innovation); William R. Kerr & Ramana Nanda, *Financing Innovation*, 7 ANN. REV. FIN. ECON. 445 (2015) (showing that VC's role in financing innovation is more prominent than that of other capital providers, such as corporate VC, sovereign wealth funds, mutual funds, and banks).

[3] See, e.g., Laura Bottazzi, Marco Da Rin, & Thomas Hellmann, *The Importance of Trust for Investment: Evidence from Venture Capital*, 29 REV. FIN. ST. 2283 (2016) (predicting that trust is a key determinant of VC investments and providing empirical evidence thereof); John Armour & Douglas J. Cumming, *The Legislative Road to Silicon Valley*, 58 OXF. ECON. PAPERS 596 (2006) (investigating the determinants of VC investing, including the law). For a literature review, see Luca Grilli, Gresa Latifi, & Boris Mrkajic, *Institutional Determinants of Venture Capital Activity: An Empirically Driven Literature Review and a Research Agenda*, 33 J. ECON. SURV. 1094 (2019).

[4] See, e.g., Leslie A. Jeng & Philippe C. Wells, *The Determinants of Venture Capital Funding: Evidence across Countries*, 6 J. CORP. FIN. 241 (2000) (finding no direct correlation between corporate law's quality and VC activity); Franklin Allen & Wei-Ling Song, *Venture Capital and Corporate Governance*, *in* CORPORATE GOVERNANCE AND CAPITAL FLOWS IN A GLOBAL ECONOMY 133 (Peter K. Cornelius & Bruce Kogut eds., 2003) (investigating the relationship between corporate governance's quality and VC and finding that creditor protection is more important than shareholder protection because of the debt-like nature of venture capitalists' claims in portfolio companies).

[5] Among economists, see, e.g., Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity*, 120 Q.J. ECON. 223, 224 (2005) (pointing out incidentally that one important way how legal regimes affect the adoption of the state-contingent contracts governing private equity deals is by imposing constraints on contracting parties); Isin Guler & Mauro F. Guillén, *Institutions and the Internationalization of US Venture Capital Firms*, 41 J. INT'L BUS. ST. 185, 190 (2010) (indicating that venture capitalists negotiate complex arrangements to secure special protections beyond those afforded under default corporate law, and that this requires legal flexibility). Among legal scholars, see, e.g., John Armour, *Law, Finance and Innovation*, *in* VENTURE CAPITAL CONTRACTING AND THE VALUATION OF HIGH-TECHNOLOGY FIRMS 133, 149-50 (Joseph A. McCahery, & Luc Renneboog eds., 2004) (discussing the importance of the flexibility of the legal regime for private companies to facilitate the adoption of U.S.-style VC contracts); Joseph A. McCahery & Erik P.M. Vermeulen, *Business Organization Law and Venture Capital*, *in id.* at 167-69 (discussing the importance of a flexible business organization law for the purposes of drafting VC contracts from a transaction cost perspective). See also Joseph A. McCahery & Erik P. M. Vermeulen, *High-tech Start-ups in*

build upon solid foundations in economic models of the optimal contractual solutions that venture capitalists[6] can use to mitigate the problems bedeviling the financing of innovative firms[7] and upon contributions from legal scholars stressing the importance of private ordering in this context.[8]

These studies, however, neither propose a conceptual framework to appreciate *how* corporate law's relative rigidity or flexibility affects VC contracting, nor shed light on the channels through which corporate law's rigidity can impede the "transplant"[9] of U.S.-style VC contracts,[10] ultimately affecting VC deal-making. Furthermore, none of these contributions has produced systematic evidence about such corporate law-VC contracting nexus.

This article fills these gaps. We show what happens to VC contracting in countries where, unlike in the U.S., corporate law in action[11] is full of mandatory rules and standards (together, also "requirements") that curtail contracting parties' ability to engineer optimal VC contracts

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Europe: The Effect of Regulatory Competition on the Emergence of New Business Forms, 7 EUR. L.J. 459, 464-67 (2001) (discussing the importance of default rules in designing a pro-VC corporate law); Paolo Giudici & Peter Agstner, *Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?)*, 20 EUR. BUS. ORG. LAW REV. 597, 606-07 (2019) (also highlighting the importance of a flexible corporate law to facilitate the adoption of U.S.-style VC contracts).

[6] We use the term "venture capitalists" to refer, depending on the context, to the financial intermediary, the funds they incorporate and manage, or those who manage the firm and the funds, colloquially known as venture capitalists.

[7] See, e.g., Thomas Hellmann, *The Allocation of Control Rights in Venture Capital Contracts*, 29 RAND J. ECON. 57 (1998).

[8] See Michael Klausner & Kate Litvak, *What Economists Have Taught Us about Venture Capital Contracting*, *in* BRIDGING THE ENTREPRENEURIAL FINANCING GAP: LINKING GOVERNANCE WITH REGULATORY POLICY 54, 59 (Michael Whincop ed., 2001); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1093 (2003) (both stressing the crucial importance of private ordering in building a VC market).

[9] Cf. Alan Watson, *From Legal Transplants to Legal Formants*, 43 AM. J. COMP. L. 469 (1995) (defining "legal transplants"). To be sure, this analogy usually refers to the import of laws (rules or sets of rules) from another jurisdiction. Yet, the literature has occasionally deployed the same terminology also to refer to the transplant of contractual arrangements. See, e.g., Heike Schweitzer, *Private Legal Transplants in Negotiated Deals*, 4 EUR. COM. & FIN. L. R. 79 (2007).

[10] Throughout this paper, we use this and similar terms, such as "VC contracts", to refer to the institutional arrangements between two or more parties that influence and coordinate strategic interactions between the individual decision makers, following Eric Brousseau & Jean-Michel Gachant, *The Economics of Contracts and the Renewal of Economics*, *in* THE ECONOMICS OF CONTRACTS: THEORIES AND APPLICATIONS (Eric Brosseau & Jean-Michel Gachant eds., 2002), 3, 3-6. Note that our discussion focuses on the contractual technology governing early-stage VC deals. The logic and the structure of VC deals occurring at a later stage in time may differ from those for early-stage projects. Importantly, the VC-related literature deploys the term "contract" to refer to both *explicit* and *implicit* arrangements. See Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets* (1998) 47 J. FIN. ECON. 243, 261. Also, we use that term to refer to the set of formally distinct but functionally and operationally intertwined contracts that govern the business relationship between shareholders, which in our context are venture capitalists and entrepreneurs. These contracts include not only the terms of the firm's charter but also ancillary contracts, such as shareholder agreements. This terminology is similar to the one deployed by financial economists, who use the same term to refer to the certificate of incorporation, the charter, the stock and purchase agreement, and a number of shareholder agreements. See, e.g., Ola Bengtsson, *Financial Contracting in the US*, *in* THE OXFORD HANDBOOK OF VENTURE CAPITAL, 478, 486 (Douglas J. Cumming ed, 2014).

[11] For the classic distinction between "law on the books" and "law in action," see Roscoe Pound, *Law on the Books and Law in Action*, 44 AM. L. REV. 12 (1910).

both per se and because of the heightened legal uncertainty that this plethora of (non-statutory) mandatory requirements creates as to what private ordering can exactly achieve in the corporate context.

Our analysis builds on a companion article providing a comprehensive analysis of the viability of the private ordering solutions found in U.S. VC contracts under German and Italian corporate law,[12] and concluding that the rigid structure of those two corporate law regimes hinders the implementation of nearly all the private ordering arrangements governing VC deals in the U.S. Parties contracting under German and Italian law are thus compelled to look for private ordering solutions that, when available at all, are inferior because they entail an increase in transaction costs and/or are less functional than the corresponding U.S. arrangements.[13]

We single out the decrease in functionality of each individual contractual component and appreciate the overall "functionality gap" between the contractual frameworks governing VC deals in the U.S., on the one hand, and Germany and Italy, on the other. Although we do not quantify the efficiency implications of this gap, our work suggests that rigid German and Italian corporate laws lead to a significant decrease in contract functionality, which in turn can deter, at the margin, VC investments.

Our article contributes to several strands of literature. First, we add to the literature on the formal and informal institutional determinants of VC investments,[14] which has so far either omitted corporate law as a variable or operationalized it solely through indices built with reference to the law on the books for publicly traded companies.[15] Second, we refine the findings of the literature that has stressed the importance of private ordering for VC investments and, hence, of corporate law's rigid versus flexible structure.[16] We do so by providing an account of *how* corporate law's rigidity hinders optimal VC contracting. Third, we add to the literature on the importance of corporate law's flexibility to stimulate VC investments and, more broadly, entrepreneurship,[17] as well as to the literature on corporate law flexibility in general[18] and on its importance in supporting financial innovation.[19] Fourth, by showing that corporate law has a huge impact on VC-backed firms and, by extension, startups' governance, we also contribute to the nascent literature documenting that differences in corporate law matter

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[12] See Luca Enriques, Casimiro A. Nigro, & Tobias H. Tröger, *Can U.S. Venture Capital Contracts Be Transplanted into Europe? Systematic Evidence from Germany and Italy* (2024) (on file with the authors).

[13] See *infra* Part III.B.2 and Part III.B.3.

[14] See *supra* note 3 for references.

[15] See *supra* note 4 for references.

[16] See *supra* note 5 for references.

[17] See, e.g., Jorge Guzman, *The Direct Effect of Corporate Law on Entrepreneurship*, 40 J. L. ECON. & ORG. 45 (2023); Simeon Djankov, Rafael La Porta, Florencio Lopez-de Silanes, & Andrei Shleifer, *The Regulation of Entry*, 117 Q. J. ECON. 1 (2002); John Armour & Douglas J. Cumming, *Bankruptcy Law and Entrepreneurship*, 10 AM. L. & ECON. REV. 303 (2008).

[18] See, e.g., Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Legal Regime and Contractual Flexibility: A Comparison of Business's Organizational Choices in France and the United States during the Era of Industrialization*, 7 AM. L. & ECON. REV. 28 (2005); Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J. L. ECON. & ORG. 340 (2006).

[19] See, e.g., York Schnorbus, *Tracking Stock in Germany: Is German Corporate Law Flexible Enough to Adopt American Financial Innovations*, 22 U. PA. J. INT'L ECON. L. 541 (2001); Katharina Pistor, Yoram Keinan, Jan Kleinheisterkamp, & Mark D. West, *Innovation in Corporate Law*, 31 J. COMP. ECON. 676 (2003); Jens Dammann, *The Mandatory Law Puzzle: Redefining American Exceptionalism in Corporate Law*, 65 HASTINGS L.J. 441 (2013).

for the allocation of cash-flow and control rights in VC-backed firms and startups.[20] Fifth, by identifying the channels through which corporate law's rigid structure can hamper the adoption of the presumptively efficient contractual framework deployed for VC deals in the U.S., we add to the literature investigating how the legal system affects financial development.[21] Sixth, by documenting how corporate law's rigidity affects the transplant of the U.S. contractual framework for VC deals in two key European jurisdictions, we add to the growing literature discussing how corporate law affects the transplant of U.S.-style contractual provisions into European Union ("E.U.") and non-E.U. jurisdictions,[22] as well as complement and refine the insights gained from the law and finance empirical literature.[23]

While we focus on U.S., German and Italian corporate laws, our analytical framework can be used to shed light on the corporate law-VC contracting nexus in any other jurisdictions. In particular, the mandatory character of corporate law in Germany and Italy is common to many E.U.[24] and non-E.U. jurisdictions.[25] Therefore, what we articulate here and in our

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[20] See, e.g., Brian J. Broughman & Jesse M. Fried, *Renegotiation of Cash-flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 384 (2010); Brian J. Broughman & Jesse M. Fried, *Carrots and Sticks: How VCs Induce Entrepreneurial Teams to Sell Startups*, 98 CORNELL L. REV. 1319 (2013); Robert P. Bartlett & Eric L. Talley, *Law and Corporate Governance*, *in* THE HANDBOOK OF THE ECONOMICS OF CORPORATE GOVERNANCE - VOL. 1 177 (Benjamin Hermalin & Michael Weisbach eds., 2017).

[21] See, e.g., Lerner & Schoar, *supra* note 5. In the legal literature, see, also for references, Mariana Parglender, *Comparative Contract Law and Development: The Missing Link?*, 85 GEO. WASH. L. REV. 1717, 1718 (2017).

[22] As to Germany, see, e.g., Theodor Baums & Matthias Möller, *Venture Capital: U.S.-amerikanisches Modell und deutsches Aktienrecht*, *in* CORPORATIONS, CAPITAL MARKETS AND BUSINESS IN THE LAW – LIBER AMICORUM RICHARD M. BUXBAUM 33 (Theodor Baums, Klaus J. Hopt, & Norbert Horn eds., 1999); Theodor Baums & Ronald J. Gilson, *The Legal Infrastructure of the German Venture Capital Market*, Goethe Universität Working Paper No. 107) (2000), *http://marshallinside.usc.edu/mweinstein/teaching/fbe532/532secure/notes/gilson%20on%20german%20venture%20capital.pdf*; THILO KUNTZ, GESTALTUNG VON KAPITALGESELLSCHAFTEN ZWISCHEN FREIHEIT UND ZWANG - VENTURE CAPITAL IN DEUTSCHLAND UND DEN USA (2016). As to Italy, see Bruna Szego, *Finanziare l'innovazione: il* venture capital *dopo la riforma del diritto societario*, 103 RIVISTA DI DIRITTO COMMERCIALE 82, 821 (2005); ANDREA ZANONI, VENTURE CAPITAL E DIRITTO AZIONARIO (2012); Giudici & Agstner, *supra* note 5; Peter Agstner, Antonio Capizzi, & Paolo Giudici, *Business Angels, Venture Capital e la nuova s.r.l.*, 8 RIVISTA ORIZZONTI DEL DIRITTO COMMERCIALE 353 (2020); Casimiro A. Nigro & Luca Enriques, Venture Capital *e diritto societario italiano: un rapporto difficile*, 20 ANALISI GIURIDICA DELL'ECONOMIA 149 (2021); Paolo Giudici, Peter Agstner, & Antonio Capizzi, *The Corporate Design of Investments in Startups: A European Experience*, 23 EUR. BUS. ORG. L. REV. 787 (2022). For references to related work on non-European jurisdictions, see *infra* note 25.

[23] See Steven Kaplan, Frederic Martel, & Per Strömberg, *How Do Legal Differences and Experience Affect Financial Contracts?*, 16 J. FIN. INT. 273 (2007).

[24] Dutch corporate law, particularly the regime for private companies, seems to stand out as a significant exception in continental Europe. For a discussion, see, in general, Lars van Vliet, *New Developments in Dutch Company Law: The "Flexible" Close Corporation*, 7 J. CIVIL L. ST. 271 (2014).

[25] For findings similar to ours regarding the impossibility of transplanting U.S.-style VC contractual arrangements in European jurisdictions, see the references *supra* note 22; and, as regards non-European jurisdictions, see, e.g., Lin Lin, *Contractual Innovation in China's Venture Capital Market,* 21 EUR. BUS. ORG. LAW REV. 101, 115-20 (2020) (claiming that one possible explanation for the adoption of "value adjustment mechanism" clauses in Chinese VC contracts is the prohibition on convertible securities and, consequently, antidilution provisions); and Alvaro Pereira, *The Law of Contingent Control in Venture Capital*, 1 COLUM. BUS. L.R. 675, , 703-11 (2023) (shedding light on the legal obstacles to contingent control-related mechanisms via security design, including convertible preferred shares and shares with multiple voting rights, in some non-European jurisdictions).

companion paper has important implications for the design of a VC market and provides valuable insights for policymakers, which we discuss and illustrate in another companion paper.[26]

This article proceeds as follows. In Part II, we describe, firstly, the structure of the VC investment process to hint at the crucial role that, according to economic theory, private ordering plays in defining VC financing relationships. Next, we take stock of the existing scholarship on the corporate law-VC investment nexus and account for its limitations. Then, we bring in our novel theory about such a nexus. An ideal pro-VC corporate law should allow venture capitalists and entrepreneurs to define any aspect of their relationship as they see fit. Yet, real-world corporate laws depart to variable degrees from that paradigm. A rigid corporate law impedes the complex private ordering exercise undertaken through VC contracting by erecting obstacles to the optimal contractual arrangements and their execution. The more a given corporate law departs from our pro-VC paradigm of corporate law, the harder contracting parties will find it to allocate cash-flow and control rights as they see fit. In addition, Part II presents a taxonomy of the channels through which rigid corporate law affects the private ordering exercise underpinning VC contracting. Rigid corporate law hampers contracting parties' ability to address governance challenges, thus decreasing the functionality and ultimately the value of contracts. Finally, we explain how these constraints translate into real-world transactional practice and eventually hinder VC deal-making, with all the ensuing repercussions for the economy at large. In Part III, we compare and contrast VC contracting under U.S. (Delaware) and European (German and Italian) corporate laws. First, we consider VC contracting under U.S. (Delaware) corporate law. We describe Delaware corporate law's general characteristics, highlight its well-known friendliness to private ordering, and sketch out the fundamental functions and features of the contractual architecture governing VC deals in the U.S. We also justify our focus on U.S. VC contracting by accounting for its presumptive efficiency. Next, we turn to VC contracting under German and Italian corporate laws. We account for the reasons why venture capitalists and entrepreneurs in Germany and Italy cannot opt out of local corporate laws, explain how we distill German and Italian corporate laws in action, and spotlight their remarkable aversion to private ordering and, specifically, VC contracting. Lastly, we provide an overview of the legal obstacles that German and Italian corporate laws erect to the adoption of the various private ordering solutions shaping efficient VC contracting. Third, we provide illustrations of how rigid German and Italian corporate laws hinder the transplant of specific components of U.S. VC contracts. Finally, we explain that, although individual contractual arrangements in German and Italian VC deals may be structurally similar to those found in U.S. VC contracts and generally even bear the same name, they regularly stop short of being as effective as their U.S. counterparts. Thus, we argue that the contractual technology available to German and Italian venture capitalists and entrepreneurs is significantly less functional and ultimately less valuable to its end-users than the one deployed on the other shore of the Atlantic. Part IV concludes.

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[26] See Luca Enriques, Casimiro A. Nigro, & Tobias H. Tröger, *The Shadow of Mandatory Corporate Law on European VC Contracting: What Implications for Market and Policymaking?*, *in* RESEARCH HANDBOOK ON THE STRUCTURE OF PRIVATE EQUITY AND VENTURE CAPITAL INVESTMENTS (Brian J. Broughman & Elizabeth de Fontenay eds., forthcoming).

II. REVISITING THE CORPORATE LAW-VENTURE CAPITAL NEXUS

VC financing relies on customized contractual arrangements for structuring investments in portfolio companies. Therefore, a flexible corporate law facilitates VC financing. Conversely, heavily prescriptive corporate law hinders it. In this Part, we first look at the significance of private ordering in VC financing relationships (Section A). We next revisit the scholarship on the relationship between the legal framework and VC financing and show why this line of research has not fully captured the role that corporate law plays in stimulating VC investments (Section B). Third, we present a novel framework to understand how corporate law's rigidity (flexibility) hinders (facilitates) VC contracting (Section C).

A. *Venture Capital Investing and Private Ordering*

Venture capitalists raise capital from institutional investors and high-net-worth individuals, pooling their monies into funds with a predetermined lifespan—normally eight to twelve years.[27] They specialize in the selection of, investment in, and provision of services (mainly in the form of advice) to early-stage firms with the potential to grow according to a "blitzscaling" trajectory,[28] knowing that they will have to liquidate each investment at the latest close to the end of a fund's lifespan.[29]

Private ordering crucially defines the legal infrastructure supporting the entire VC investment process,[30] including venture capitalists' cooperation with entrepreneurs within VC-backed firms.[31] The relevant contract serves two key purposes. First, the contractual arrangements shaping VC-backed firms' financial and governance structure are instrumental to addressing the multiple challenges bedeviling the financing of innovative high-tech projects.[32] For instance, liquidation rights that depart from default corporate law and combine decision-making authority and preferential cash-flow claims in the event of firm termination can be used to screen for skilled entrepreneurs and good projects;[33] performance-based arrangements can

[27] 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, 253 (2020) (reporting that a persistent contractual term in the partnership agreement governing VC funds stipulates an 8-to-10-year lifespan with the possibility of a 1-to-2-year extension upon the approval of the VC fund investors).

[28] Blitzscailing is the rapid building of a company to serve large, typically global, markets. For an account of blitzscaling as a model for entrepreneurial development and some examples that operationalize it, see Donald F. Kuratko, Harrison L. Holt, & Emily Neubert, *Blitzscaling: The Good, the Bad, and the Ugly*, 63 BUS. HOR. 109 (2020).

[29] See Gilson, *supra* note 8, at 1074-75 (hinting at the pressure that venture capitalists face as the VC fund matures).

[30] Gilson, *supra* note 8, at 1069 ("the keystone of the U.S. venture capital market is private ordering").

[31] Id., at 1078 (discussing the pivotal role of contract, along with reputation, in shaping the governance of VC-backed firms).

[32] See generally Josh Lerner, *The Governance of New Firms*, *in* FINANCING INNOVATION IN THE UNITED STATES – 1870 TO PRESENT 405, 406-09 (Naomi R Lamoreaux & Kenneth L. Sokoloff eds., 2005).

[33] Cf. Stephen Ross, *The Determination of Financial Structure: The Incentive Signalling Approach*, 8 BELL J. ECON. 23 (1977).

counteract the non-contractibility problem of the entrepreneur's optimal level of effort;[34] and preventing the entrepreneur from leaving by making his exit costly tackles the hold-up problem.[35]

The arrangements between the venture capitalist and the entrepreneur are also instrumental to "braiding" the essential features of VC-backed firms with the VC funds' business model on both the organizational and operational levels.[36] While VC funds invest in many companies to diversify risk, venture capitalists still want control rights to protect their investment, which implies power disproportionate to their equity stake in portfolio companies.[37] As portfolio value-maximisers, venture capitalists have incentives to force the exchange of information between competing firms that are in different positions in the race to bring their products to the market.[38] Finally, from the venture capitalist's perspective, timely divestment—whether through IPOs, trade sales, redemptions, or write-offs[39]—is key to meeting the VC fund's promise to liquidate at the end of its lifespan,[40] and thereby to building a reputation as a trustworthy asset manager, which is essential to stay in business.[41] Hence, the venture capitalists' insistence on exit rights, allowing them to cash out even if value-creating divestment strategies are unavailable.[42]

Overall, venture capital financing requires a unique contractual framework that systematically differs from the standard governance structures stipulated in corporate law and used by both public and private companies.[43] The resulting control allocation varies over time and depending on contingencies.[44] Similarly, in some states of the world, firm value allocation will be extremely asymmetric, i.e., deviate significantly from pro-rata distributions. Designing asymmetric payoffs contingent on success (or lack thereof) gives entrepreneurs strong incentives to perform.[45] At the same time, such payoff structures allow venture capitalists to minimize the downside risk caused by the facts that, on the one hand, most VC-backed firms

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[34] Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74.

[35] Oliver Hart & John Moore, *A Theory of Debt Based on the Inalienability of Human Capital*, 109 Q. J. ECON. 841 (1994).

[36] Gilson, *supra* note 8, at 1091 (discussing the "braiding" of the contractual framework governing venture capitalists and portfolio companies as regards exit).

[37] See Andrei A. Kirilenko, *Valuation and Control in Venture Finance*, 56 J. FIN. 565, 565 (2002).

[38] Sudipto Bhattacharya & Gabriella Chiesa, *Proprietary Information, Financial Intermediation, and Research Incentives*, 4 J. FIN. INT. 328 (1995).

[39] For an overview of venture capitalists' divestment techniques, see Gilson, *supra* note 8, at 1075.

[40] See, e.g., Michael Klausner & Stephen Venuto, *Liquidation Rights and Incentive Misalignment in Start-up Financing*, 98 CORNELL L. REV. 1399, 1401-02 (2013).

[41] See Paul A. Gompers, *Grandstanding in the Venture Capital Industry*, 42 J. FIN. ECON. 133 (1996).

[42] Cf. Gilson, *supra* note 8, at 1075.

[43] Cf. Robert P. Bartlett III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation* 54 UCLA L. REV. 37 (2006) (pointing out that the arrangements governing VC-backed firms depart in many crucial respects from those governing as a *tertium genus* relative to the widely and closely held corporations).

[44] Kirilenko, *supra* note 37, at 565 ("Control is not an indivisible right held at any one time by either an investor or an entrepreneur, but rather a continuous variable that is adjusted and fine-tuned through a multitude of contingent provisions […].").

[45] See *supra* text accompanying note 34.

when they don't just fail, do not blitzscale,[46] and, on the other, overall portfolio performance also depends on low-performing investments returns.[47]

Finally, the terms of VC contracts that seek to prescripe the parties' behavior follow a precise "filtering" logic that avoids rigid categorizations in defining which actions are permissible and which are not.[48] Instead, these incomplete contracts[49] require enforcers to carry out an in-depth investigation into the economic rationale of the contract and the litigated facts to understand what actions are compliant with, or in breach of, the contracting parties' original promises.[50]

B. *Corporate Law and Venture Capital*

Against this background, it is unsurprising that the law and finance scholarship has investigated whether and how (corporate) law can affect VC contracting and, eventually, VC investments.[51]

Scholars have found that common law jurisdictions enjoy a competitive advantage thanks to superior investor protection[52] and that, due to more reliable enforcement of contracts, such jurisdictions facilitate the adoption of complex state-contingent arrangements that allocate cash-flow and control rights separately.[53] One study that analyzed the impact of legal regimes on VC contracts more granularly found cross-jurisdictional variation but concluded that

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[46] For the relevant statistics see Elizabeth Pollman, *Startup Failure*, 73 DUKE L.J. 327, 329-30 & nn. 6-7 (2023).

[47] See Sven Riethmueller, *Rise of the Zombies: The Significance of Venture Capital Investments That Are Not Profitable*, 22 HOUS. BUS. & TAX L.J. 98 (2021) (explaining through some simulations of the impact of liquidation preferences on overall portfolio returns that extracting value from non-highly performing VC-backed firms is crucial for VC firms).

[48] "[P]recisely filtering contracts" are "[…] contracts [that] provide protection to investors only when it is necessary: i.e. in the eventualities that expropriation can occur, and only in these eventualities. Precisely filtering contracts, therefore, bar expropriation without barring firms from performing other, possibly efficient actions. In this sense, they act as a filter, blocking expropriation while allowing other firm actions to be taken. Nittai K. Bergman & Daniel Nicolaievsky, *Investor Protection and the Coasian View*, 84 J. FIN. ECON. 738, 740 (2007).

[49] See generally, Philippe Aghion & Richard Holden, *Incomplete Contracts and the Theory of the Firm: What Have We Learned over the Past 25 Years?*, 25 J. ECON. PERSP. 181 (2011).

[50] Cf. Bergman & Nicolaievsky, *supra* note 64, at 740.

[51] For a survey of the main contributions see, e.g., Grilli, Latifi, & Mrkajic, *supra* note 3, at 1099-1111.

[52] See Stefano Bonini & Senem Alkan, *The Political and Legal Determinants of Venture Capital Investments around the World*, 39 SMALL BUS. ECON. 997 (2012) (testing and confirming, *inter alia*, the hypothesis that countries of English origins are friendlier to VC due to their higher investor and creditor protection). But the significance of English legal origin is found to decline when investor protection is added to the econometric specification. See Raj Aggarwal & John W. Goodell, *Cross-national Differences in Access to Finance: Influence of Culture and Institutional Environments*, 31 RES. INT. BUS & FIN. 193 (2014). This seems to suggest a potential substitution effect between the two constructs.

[53] See Lerner & Schoar, *supra* note 5, at 225. See also Guler & Guillén, *supra* note 5, at 189-90 (arguing that poor investor protection calls for an increase in ownership and costlier monitoring, inducing venture capitalists to increase the size of their equity interests and their presence on the board against entrepreneurs' preferences, which in turn causes entrepreneurs to be less inclined to close deals because of the additional equity stake demanded by venture capitalists).

corporate law quality does not play a major role.[54] It found "no substantive differences across low and high minority [shareholder] protection countries," because "there appear to be few institutional impediments to implementing U.S.-style [contract] terms," particularly for more experienced venture capitalists.[55]

This strand of research, however, has focused too narrowly on features of corporate law that have little to no connection with the characteristics of VC-backed firms and their governance.[56] Also, while economists and legal scholars have generically stressed the importance of corporate law's flexibility,[57] their research has looked almost entirely at corporate law on the books. However, corporate law on the books may give a very partial picture of how corporate law affects VC contracting. This is particularly the case where "metarules", that is, "the rules developed by a legal system (or, more accurately, by the actors within a legal system) in order to help it manage its body of rules."[58], leave ample scope for creative interpretations of corporate law. In some jurisdictions, metarules enable scholars, practitioners, and courts to create new mandatory rules and standards. On their basis courts can qualify contractual provisions as null and void and/or second-guess how the ensuing rights are exercised to a much wider extent than what the law on the books would appear to warrant. As a by-product of this extra-legislative rule creation, legal uncertainty casts its shadow well beyond what would be observed in jurisdictions whose corporate law is deferential to private ordering.[59]

Furthermore, in determining whether venture capitalists and entrepreneurs can achieve a given result through private ordering, that literature has built upon an incomplete understanding of what constitutes a functionally equivalent arrangement.[60] Finally, existing scholarship has considered only the constraints that corporate law imposes on specific contractual solutions without properly considering the possible synergies between contractual clauses.[61]

As a result, this literature only partially explains how corporate law affects venture capitalists' and entrepreneurs' ability to design agency cost-minimizing governance structures and, thus, how it affects VC investments. In the next Section, we bring in a novel theoretical framework that overcomes these limitations.

C. *Inflexible Corporate Law Constraints and Optimal Contracting*

This Section advances our understanding of the corporate law-VC nexus by zooming in on what happens when venture capitalists and entrepreneurs engage in the complex private

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54 See Steven Kaplan, Martel, & Strömberg, *supra* note 23, at 289.

55 *Id.*, at 308.

56 Armour & Cumming, *The Legislative Road*, *supra* note 3, at 600 (noting that indices expressing the quality of corporate law in individual countries (such as what has become known as the LLSV index: see Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998)) offer little insight into the understanding of VC financing arrangements, which are mostly a function of contractual choices).

57 See *supra* note 5 for references.

58 Pierre Legrand, *European Legal Systems Are Not Converging*, 45 INT. & COMP. L.Q. 52, 57 (1996).

59 See *infra* Part III.B.1.b.

60 See *infra* Part II.C.2.

61 See *infra* Parts II.C.3.a and III.B.3.b.iv.

ordering exercise required to shape the governance of their relationship under a rigid corporate law framework.

Although we build on our findings on how German and Italian corporate laws affect VC contracting,[62] we nonetheless deliver a generally applicable framework with broader policy implications that we discuss in another companion paper.[63] A holistic theoretical framework that shows in detail how corporate law's rigidity affects VC contracting and deal-making can help policymakers and legislators envision solutions to improve the corporate law environment for VC-backed firms.[64]

This Section first outlines the features that corporate law should display to be favorable to VC contracting and calls for shifting the focus from corporate law on the books to corporate law in action when analyzing the private-ordering hospitality of a specific corporate law framework (Section 1). Next, it theorizes how transaction costs can act as a marginal impediment to efficient VC contracting when corporate law is rigid (Section 2). Then, it outlines the channels through which corporate law's rigidity can impede efficient VC contracting (Section 3). Finally, it explains how the constraints stemming from rigid corporate law enter into transactional practice and ultimately affect VC deal-making (Section 4).

1. A pro-venture capital deal model of corporate law in action

VC-backed companies require customized governance structures,[65] so flexible corporate law is essential to their success. Consistent with the premise that sophisticated contracting parties know how to protect their interests,[66] we define a corporate law as optimally flexible for VC contracting if it: (a) adopts a hands-off approach regarding the enforceability of private ordering solutions that shape VC transactions; (b) refrains from employing ex post gap-filling mechanisms that might restrict the exercise of parties' rights in ways inconsistent with the economic rationale of their agreements,[67] and (c) punishes the abusive exercise of such rights, thereby defining abuse as self-serving behavior that violates the economic purpose of the VC deal.[68] In other words, corporate law should ideally allow parties to define all aspects of the

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[62] Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12.

[63] See Enriques, Nigro, & Tröger, *The Shadow of Mandatory Corporate Law*, *supra* note 26.

[64] For instance, legislators are taking actions aimed to introduce specific business forms for startups. Austria has recently adopted a flexible corporate form named "FlexKapGG". For details, see HERMANN SCHNEEWEISS & FLORIAN HULE (Eds.), PRAXISKOMMENTAR ZUR FLEXIBLEN KAPITALGESELLSCHAFT, 2024. Further, the so-called Draghi Report has stressed the importance of corporate law in supporting high-tech firm's access to capital across Europe and advocated a special pan-E.U. corporate law regime for such firms. See EU Commission, *The Future of European Competitiveness — A Competitiveness Strategy for Europe*, 9 September 2024, https:*//commission.europa.eu/topics/strengthening-european-competitiveness/eu-competitiveness-looking-ahead_en*, at 29-30.

[65] See *supra*, Part II.A.

[66] Cf. Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 J. CORP. L. 185 (1992) (positing that regulatory intervention is unwarranted if contracting parties can fend for themselves).

[67] Depending on the jurisdiction, these mechanisms receive different denominations, such as "fiduciary" or "good faith" duties. See Mariana Pargendler, *Modes of Gap Filling: Good Faith and Fiduciary Duties Reconsidered*, 82 TUL. L. REV. 1315 (2008).

[68] To be explicit, the point is to tackle abuse that contradicts the economic rationale of the agreement. When abuse is understood as conduct violating heteronomous legal principles, the legal system may inhibit actions that

venture capitalist-entrepreneur relationship by contract, including the fundamental determinants of the relevant tools to fill gaps ex post. The law (and its enforcement actors) should only interfere with private agreements if any party deviates from the economic rationale of the relevant contract—that is, when parties abuse their rights—thereby protecting the contract against ex post opportunism.[69]

Under a corporate law that defers entirely to private ordering in defining the governance of the business relationship, VC contracts emerge as a reliable source of the various rules and standards defining the obligations of venture capitalists and entrepreneurs. As a result, legal uncertainty is virtually absent. That is, the risk of legal interventions disrupting the intended contractual arrangements in VC deals is extremely low.

To assess how far a specific jurisdiction's corporate law deviates from this ideal requires gauging such corporate law's relative rigidity or flexibility. This assessment, in turn, calls for embracing a notion of corporate law that also encompasses how it is interpreted and applied, that is, looking at corporate law in action.[70] Hence, we must consider any precept—explicitly stated in statutes or derived from their interpretations—that affects contracting parties' ability to tailor organizational contracts to their needs. Therefore, the analysis must encompass metarules that determine how relevant players interpret and apply (corporate) law.[71] Moreover, it does not matter whether any so derived precept falls formally within the domain of corporate law or other domains, such as contract law.[72] This task of teasing out the relevant corporate law in action can pose significant methodological challenges,[73] but it is nonetheless essential for analyzing the corporate law-VC nexus.

2. Transaction costs as a marginal impediment to venture capital deals

Under the ideal pro-VC corporate law, assuming that no material transaction costs exist and that parties are sophisticated, venture capitalists and entrepreneurs can allocate cash-flow and control rights as they want. By doing so they can maximize their joint utility in a Coasian bargain, no matter how applicable corporate laws may have allocated those rights within VC-backed firms by default.[74]

The assumptions of negligible transaction costs and parties' sophistication are realistic. Transaction costs are spread across the industry via copycat behavior and standardization: they

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neither of the parties to a contract would have thought of ex ante as contrary to the expectations and reciprocal understandings underlying their relationship.

[69] For the basic theory see Oliver Williamson, THE ECONOMIC INSTITUTIONS OF CAPITALISM 33 (1985).

[70] Pound, *supra* note 11.

[71] See *supra* note 58 and corresponding text.

[72] For instance, general contract law may have a bearing on VC contracting because in many jurisdictions, corporations have a contractual basis. See, e.g., KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 17 (3d ed., 2017).

[73] While clear on the conceptual level, the notion of law in action poses challenges when it comes to determining what, in a specific jurisdiction, the law in action is. For details on how we determine the relevant content of the law in action in the U.S. and then Europe, see *infra* Part III.A.1. and Part III.B.1.b.

[74] See generally, Ronald H. Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1, 8 (1960). For an application to the corporate contract, see FRANK EASTERBROOK & DANIEL FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

are thus insignificant for individual VC deals.[75] In addition, venture capitalists are repeat players, while founders, when they are not repeat players themselves, are only mature for VC funding after advancing beyond the potentially chaotic initial phase of their venture.[76] Hence, they will strike a VC deal at a time when they should possess sufficient sophistication and resources to access professional legal advice. In addition, even assuming a disparity in expertise, a venture capitalist would leave money on the table if it did not proactively propose arrangements that benefit the entrepreneur more than they cost the venture capitalist itself.[77]

Yet, existing corporate laws often depart from our pro-VC corporate law paradigm, thus imposing legal restrictions on venture capitalists and entrepreneurs that may have lasting and meaningful effects on their ability to strike a Coasian bargain.[78]

One may be inclined to think that sophisticated contracting parties, with their lawyers' help,[79] can replace a prohibited contractual arrangement with another that performs the same function but remains in line with the applicable law. If the permissible arrangement enables contracting parties to *achieve the same practical result* as the prohibited arrangement *at no higher costs*, then it is indeed a functionally equivalent solution[80] to the private ordering challenge. Such a solution makes the corporate law prohibition irrelevant for all practical purposes (save for lawyers' efforts to identify the way around the prohibition).

The key qualifier in our characterization of a different arrangement as functionally equivalent is "at no higher costs."[81] In fact, there is no functional equivalence if the costs and the effectiveness of two arrangements are different (for instance because legal uncertainty as to

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[75] D. Gordon Smith, Matthew Wright, & Marcus Kai Hintze, *Private Ordering with Shareholder Bylaws*, 80 FORD. L. REV. 125, 188 (2011) (explaining how private ordering through shareholder-adopted bylaws can "create laboratories of corporate governance that benefit the entire corporate governance system."). For a broader discussion Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or: The Economics of Boilerplate)*, 83 VA. L. REV. 713 (1997) (analyzing the economics of innovation and standardization of the corporate contract with a focus on learning effects across the corporate governance system).

[76] See Will Gornall & Ilya A. Strebulaev, *The Contracting and Valuation of Venture Capital-backed Companies*, *in* HANDBOOK OF THE ECONOMICS OF CORPORATE FINANCE. VOL. 1 (Bjorn E. Eckbo, Gordon M. Phillips & Morten Sorensen, eds., 2023), 3, 8-9 (discussing how various financiers extend support to startups and reporting that venture capitalists usually invest in firms with relatively high valuations to help develop further an already envisioned if not tested product or service).

[77] *See generally* Coase, *supra* note 74.

[78] *Id*.

[79] On lawyers' role in engineering the most effective transactional solutions, see Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984).

[80] To be clear, our own definition of functional equivalence is different from the one traditionally deployed in the comparative law literature. Comparative law scholars identify the subject matter of their comparisons by isolating institutions of structurally different legal systems that perform the same function. See Ralf Michaels, *The Functional Method of Comparative Law*, *in* THE OXFORD HANDBOOK OF COMPARATIVE LAW 345, 350 (Mathias Reimann & Reinhard Zimmermann eds., 2d ed. 2019). Functionally equivalent institutions in that general sense are institutions that, despite being possibly located in different domains of the legal system, address the same ordering intent. This concept only facilitates comparability, whereas our definition includes an efficiency assessment, not present in traditional comparative law scholarship; cf. *id*. at 372, 379.

[81] By contrast, in the literature on VC contracting, scholars often argue or implicitly endorse the view that any contractual arrangement that achieves the same result as the optimal one is an effective substitute, giving no consideration to the related costs. See e.g., Kaplan, Martel, & Strömberg, *supra* note 23, at 291-92, and Giudici, Agstner, & Capizzi, *supra* note 22, at 814 (both implicitly adopting that notion when analyzing the impact of Italian corporate law on local VC contracting).

their validity or enforcement costs are higher in one case than in the other) and thus the value to their end users is different.

The problem is that rigid corporate law may subject functionally equivalent solutions to the same regime as the prohibited arrangement. This may be the case because a wide-ranging precept explicitly prohibits all arrangements that achieve a specific result, no matter what form it takes. Alternatively, metarules may enable courts to invalidate (also) functionally equivalent arrangements exactly because they achieve the same practical result as the forbidden arrangement they seek to replace.[82]

When that is the case, contracting parties can only resort to arrangements that perform a function similar or identical to the private ordering solution they seek to mimic, and yet, unlike functionally equivalent solutions,[83] are costlier and/or less effective. We call these costlier and/or less functional transactional solutions "inferior alternative arrangements." When only such arrangements are available or, even worse, when parties cannot even resort to them, which may be the case when rules or standards extend to inferior arrangements as well, corporate law constraints become non-trivial, because they negatively affect the ability of contracting parties to achieve their goals through private ordering.

3. A taxonomy of corporate law constraints

Thus far, we have identified the law in action as the source of the various rules and standards shaping transactional practice and have provided a framework based on general transaction cost theory to account for how corporate law's relative rigidity can affect VC contracting. Now, we outline the universal characteristics of the constraints through which a rigid corporate law hinders efficient VC contracting and ultimately spawns welfare losses. We identify two types of constraints: (a) prohibitions; and (b) legal uncertainty.

a. Prohibitions: absolute and relative

Corporate law's negative impact on private ordering can be the function of prohibitions that can be either "absolute" or "relative."

Absolute prohibitions prevent contracting parties from incorporating in their deal *both* a given private ordering arrangement *and*—possibly with the support of general anti-evasion standards or other doctrines and metarules—any functionally equivalent solutions or even inferior alternative arrangements.

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[82] Legal systems across the globe deploy a number of regulatory techniques—ranging from explicit corporate law provisions to various doctrines—in order to prevent economic agents from resorting to transactional solutions formally different from those that a given regime regulates in order to circumvent mandatory law. Tax law scholars have put much effort into investigating these regulatory techniques from an economic perspective, delivering insights that are of general applicability beyond legal domains. One such regulatory technique consists in emphasizing the economic substance of the transaction—as opposed to its form—to subject it to the mandatory regime economic agents sought to circumvent. See, e.g., David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 AM. L. & ECON. REV. 88 (2002). Corporate law deploys some such techniques as well. For an example, see KRAAKMAN ET AL., *supra* note 72, at 229. As corporations have a contractual basis (see *supra*, note 72), general contract law-based anticircumvention rules and doctrines apply.

[83] For the relevant definition see *supra*, text accompanying notes 80-81.

Relative prohibitions instead rule out the viability of a specific private ordering solution but allow contracting parties to adopt inferior alternative arrangements.[84] The inferior functionality of these arrangements may depend on several factors.

First, a private ordering solution may be held to be legitimate, only if additional elements, that happen to prevent parties from achieving the desired allocation of cash-flow and/or control rights, are also part of the arrangement, thus decreasing its functionality. We can call this phenomenon "prohibition by addition."

Second, inferior functionality may depend on the fact that the law makes a contractual arrangement legal only to the extent that it finds its place in a shareholder agreement rather than in the firm's certificate of incorporation, charter or bylaws (hereinafter, for brevity, we'll refer to these documents as the firm's charter). In principle, including a given provision in the firm's charter is not always the optimal approach, because in some instances sound reasons (*e.g.*, confidentiality) may suggest including private ordering solutions in shareholder agreements.[85] Yet, sophisticated parties should be able to make efficient choices. Therefore, when venture capitalists and entrepreneurs are required to include specific provisions in a shareholder agreement, they may be forced to make arrangements that are less economically efficient than they would otherwise have chosen. The "mandated relocation" of a given contractual arrangement in a shareholder agreement may in fact decrease its functionality for several reasons. To begin with, unlike arrangements in the firm's charter, which bind not only the shareholders but also the board itself, those in shareholder agreements may bind, depending on the jurisdiction, only those who sign them, typically some or all of the shareholders.[86] Further, while rights set out in the firm's charter can usually be enforced against all shareholders and the firm itself, breaches of shareholder agreements usually entitle signatory shareholders only to contractual remedies against their counterparties.[87] Finally, only rights set out in the firm's charter can be self-enforcing, that is, independent of external enforcement. In that sense, contractual provisions can be enforced without depending on the founder's cooperation. Moreover, contracts can grant the venture capitalist rights that can be used in various scenarios to indirectly induce the entrepreneur to comply with the contract.

Third, inferior functionality may follow from the requirement that an arrangement is subject to judicial review—for fairness or similar—of its terms and/or the exercise of the rights it grants. Such judicial review can be based upon corporate law rules or standards, including fiduciary duties and similar ex post gap-filling techniques.[88]

Fourth, inferior functionality may derive from losing the synergies between one contractual arrangement and another. When corporate law prohibits a given optimal contractual arrangement, its unavailability may make another, non-prohibited contractual arrangement (even) less effective, if the latter relies on the former to achieve its ends.

Note that a rigid corporate law regime may subject a specific private ordering solution to a regulatory treatment that causes a decrease in functionality for more than one of the reasons

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84 For the relevant definition, see *supra* text accompanying note 83.

85 Gabriel Rauterberg, *The Separation of Voting and Control: The Role of Contract in Corporate Governance*, 38 YALE J. ON REG. 1124, 1148 (2021).

86 Corporate law's approach to this issue varies across jurisdictions. For an overview, see Alvaro Pereira, *supra* note 25, at 707 .

87 *Id.*, at 709.

88 See *supra* note 67.

listed above. For instance, rigid corporate law may stipulate that a given private ordering solution both must be relocated to a shareholder agreement *and* is subject to judicial review.

b. Legal uncertainty

Corporate law's negative impact on private ordering can also be a function of the uncertainty of the legal regime applicable that determines the validity, and/or enforceability of a given private ordering solution, and/or how contracting parties should exercise the ensuing rights.

Legal uncertainty is a phenomenon common to all jurisdictions.[89] In some jurisdictions, however, legal uncertainty is more pronounced because local metarules grant scholars, legal gatekeepers, courts, and arbitrators broad discretion in interpreting corporate law, including the use of implicit rules and standards to overrule contractual arrangements and/or the second-guess the ensuing rights in a way inconsistent with their economic rationale. Importantly, once elaborated, these implicit rules and standards become parts of corporate law and, thus, can themselves be relied on to identify additional rules and standards, and so on.

In these jurisdictions, scholars, legal gatekeepers, courts, and arbitrators habitually create new mandatory corporate law requirements, which makes it significantly harder to confidently tell what corporate law stipulates *at any given point in time*, let alone in the future. As a result, the corporate law treatment of a specific contractual arrangement may be hard to identify. Unexpectedly, the arrangements may be found to clash with "new" requirements of corporate law that may emerge, in their particular form, only after the contract was entered into. We term this phenomenon "extreme legal uncertainty" to set it apart from the inevitable residual legal uncertainty that afflicts any jurisdiction.

Where extreme legal uncertainty exists, the heightened litigation risk decreases contractual functionality and value significantly.[90] Economic agents rightfully harbor the expectation that they could successfully tease out "dormant" or "unnoticed" implicit corporate law requirements and nudge courts or arbitrators into relying on such rules and standards with no solid anchor in the statutes, existing legal scholarship, or prior case law[91]—a strategy that is a non-starter in jurisdictions that largely defer to private ordering.[92]

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[89] See, e.g., Giuseppe Dari-Mattiacci & Bruno Deffains, *Uncertainty of Law and the Legal Process*, 163 J. INST. & THEOR. ECON. 627, 628-629 (2007) (arguing that legal uncertainty is an inherent feature of any legal system due to interpretative ambiguity of authoritative texts such as statutes and precedents).

[90] On the impact of legal uncertainty and the risk of litigation on contract value, see Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, *in* THE HANDBOOK OF LAW AND ECONOMICS 3, 7-12 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (taking stock of the variables affecting contract value); Kevin E. Davis, *Contracts as Technology*, 88 N.Y.U. L. Rev. 83, 98 (discussing the many ways in which legal uncertainty decreases contract value).

[91] For an attempt to model the relationship between legal uncertainty and the likelihood of litigation, see George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEG. ST. 1 (1984).

[92] Germany and Italy, as we shall document later on, emerge as two examples of jurisdictions in which contracting parties can lever virtually any explicit and implicit corporate law requirements to litigate their contracts. See *infra* Part III.B.1. By contrast, U.S. corporate law, despite a huge body of case law on fiduciary duties in principle susceptible to a creative discovery of restrictions for private ordering, has a long-standing tradition of judicial deference to private ordering and can, therefore, serve as the most proximate example of such jurisdiction. See *infra* Part III.A.1.

4. Corporate law constraints, transactional practice, and deal-making

The absolute and relative prohibitions we have outlined in Part II.C.3 can stem from blackletter corporate law or its interpretation. These prohibitions can penetrate real-world transactional practice via two channels. One such channel is legal gatekeepers—for instance, corporate counselors and notaries—involved in drafting VC contracts, who may intervene ex ante. The other channel is courts and arbitrators, who may intervene ex post to adjudicate disputes about the validity or enforceability of a private ordering solution or the exercise of the ensuing rights.

Legal uncertainty finds its way into transactional practice via the latter channel. No matter how carefully legal gatekeepers may have designed specific contractual arrangements and sought to predetermine contracting parties' exercise of their prerogatives, discontent parties may still lever on "hidden" requirements to litigate contractual arrangements that prove disadvantegous to them ex post. Particularly because scholars or enforcers may have minted new requirements after the deal closed,[93] adjudication can lead to the severe disruption of VC contracts, challenging the validity of their individual components or the latitude of the discretion that contracting parties enjoy in exercising their rights.

Absolute and relative prohibitions imply that venture capitalists and entrepreneurs may not fully realize their objectives through private ordering, leaving governance challenges only partly addressed at best. Legal uncertainty (particularly if extreme) implies that contracting parties cannot be reasonably sure that the contractual framework they have bargained for will withstand significant disruptions at the litigation stage.

Where mandatory corporate law adversely affects private ordering, contracting parties will strike VC deals only at suboptimal conditions, negatively affecting VC-backed firms' cost of capital. Evidence suggests that contracting parties' inability to adopt optimal VC contracts should result in lower firm valuations.[94] At the margin, this can result—as empirical studies portend[95]—in fewer startups obtaining VC funding, ultimately affecting growth and innovation.

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[93] See *supra* Part II.C.3.b.

[94] See Lerner & Schoar, *supra* note 5, at 225 ("[w]e find that firms' valuations are significantly higher in nations with a common law tradition, and superior legal enforcement and private equity funds investing in common law countries enjoy higher returns.").

[95] As to the adverse impact of legal rigidity on startups' access to VC financing, *cf.* Ofer Eldar, Jillian Grennan, & Katherine Waldock, *Common Venture Capital Investors and Startup Growth*, 37 REV. FIN. STUD. 549, 576-78 (2023) (documenting empirically that the Delaware legislator's choice to allow for waivers of the corporate opportunity doctrine increased startups' access to VC); and Bo Bian, Yingxiang Li, & Casimiro A. Nigro, *Conflicting Fiduciary Duties and Fire Sales of VC-backed Start-ups* (LawFin Working Paper No. 35, 2022), *https://ssrn.com/abstract=4139724* (documenting empirically how imposing on venture capitalists fiduciary standards that prevent them from exercising their rights as implicitly stipulated in the contract may stifle startups' access to VC financing). As to the adverse impact of legal uncertainty on startups' access to VC financing, instead, *cf.* Lubomir P. Litov, Xia (Summer) Liu, & Romora E. Sitorus, *The Effect of Policy Uncertainty on VC Investments Around the World*, 8 J. L., FIN., & ACC. 1 (2024) (documenting empirically the adverse impact of policy uncertainty on VC financing along many dimensions).

III. VENTURE CAPITAL CONTRACTING: THE U.S. *VS* EUROPE

In Part II, we argued that what matters for VC investments is corporate law in action and outlined the key features of a pro-VC corporate law and the channels through which a rigid corporate law hinders efficient VC contracting. We also explained how the ensuing constraints penetrate transactional practice.

This Part now tests this hypothesis by comparing and contrasting VC contracting under U.S. (Delaware) corporate law, on the one hand, and German and Italian corporate laws, on the other. We first discuss VC contracting under U.S. corporate law and stress that its flexibility has led to the engineering of a contractual framework that has eventually emerged as the best real-world solution to the problems of startup financing (Section A). Then, we illustrate how German and Italian corporate laws, when they do not stipulate absolute prohibitions, impose relative ones, leaving venture capitalists and entrepreneurs with no choice but adopting inferior alternative arrangements (Section B). We provide only a few illustrations here which are based on a companion paper presenting systematic evidence that German and Italian corporate laws stand in the way of transplanting nearly all the individual components of U.S. VC contracts.[96] We finally show that contracts governing VC deals in Germany are less functional than their U.S. counterparts (Section C).

A. Unfettered Private Ordering in the U.S.

This Section accounts for Delaware corporate law's friendliness to private ordering and explains how this characteristic has played a crucial role in engineering U.S. VC contracts.

We provide a brief account of how Delaware corporate law works (Section 1) before we pinpoint the functions and features of the contractual framework governing VC deals in the U.S. (Section 2). Finally, we substantiate the presumptive efficiency of that contractual framework, justifying why it constitutes the reference point for VC transactional practice globally (Section 3).

1. Delaware corporate law

Delaware corporate law in action—that is, the Delaware General Corporation Law ("DGCL") as interpreted and applied by the local judiciary—displays all the four features we ascribe to the flexible corporate law regime we have identified as ideal for VC contracting.[97]

Delaware corporate law is generally most friendly to private ordering. Not only does blackletter corporate law, by design, take a pro-private ordering approach,[98] but scholars also

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[96] See Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12.

[97] See *supra* Part II.C.

[98] See, e.g., Leo Strine Jr., *The Delaware Way: How We Do Corporate law and Some of the New Challenges We (and Europe) Face*, 30 DEL. J. CORP. L. 673, 674-75 (2005) (stating that Delaware corporate law largely consists of default provisions); Edward P. Welch & Robert S. Saunders, *Freedom and Its Limits in the Delaware General Corporation Law*, 33 DEL. J. CORP. L. 845, 848-55 (2008) (recalling in detail the provisions of Delaware corporate law that serve as foundations of its flexibility).

strenuously defend the idea that private ordering has a prominent role in defining corporate governance.[99] Practitioners share that view, with corporate counselors exploiting the afforded leeway to engineer the most effective transactional solutions possible.[100] Public notaries are not responsible for the legality of the transactions brought before them and have no veto power on private ordering solutions.[101] Courts also refrain from taking an interventionist approach,[102] which occurs only in those isolated cases where contractual components clash with the few existing mandatory corporate law provisions and thus raise severe public policy concerns.[103] In those isolated instances in which corporate law may prevent contracting parties from including a given contractual arrangement in the firm's charter,[104] contracting parties can resort to shareholder agreements. Such a relocation of private ordering solutions not only eschews the (however loose) constraints of Delaware corporate law[105] but, if entered into by sophisticated parties, is also subject to an even less strict public policy-based scrutiny.[106] This enables venture capitalists and entrepreneurs to agree on almost anything they want.[107] As a result, in the rare cases where the enforceability of the individual components of U.S. VC contracts has

[99] See e.g., Johathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective* (1992) 18 J. CORP. LAW 185, 211 (strongly advocating, conclusively, a liberal approach to framing corporate law as a set of mere default rules).

[100] See generally Gilson, *supra* note 79.

[101] For details, see, e.g., CNI Notary Institute, 2023 NEW YORK NOTARY PUBLIC HANDBOOK (13th ed., 2023). This stands in stark contrast with the role of notaries in Continental Europe. See *infra*, Part III.B.1.c.

[102] See Jones Apparel Group v. Maxwell Shoe Co., 883 A.2d 837,845 (Del. Ch. 2004) ("Delaware's corporate statute is widely regarded as the most flexible in the nation because it leaves the parties to the corporate contract (managers and stockholders) with great leeway to structure their relations …").

[103] See Welch & Saunders, *supra* note 98, at 848-51(explaining that Section 102(1)(b) of the DGCL grants incorporators great freedom in shaping their governance arrangements, that it bars only contractual solutions that are "contrary to the law" of Delaware, that the meaning of this clause has always been "narrowly construed," and that case law—namely Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 118 (Del. 1952)—has stated that it rules out only certificate of incorporation provisions that would "achieve [a] result forbidden by settled rules of public policy.").

[104] See, e.g., Jill E. Fisch, *A Lesson from Startups: Contracting Out of Shareholder Appraisal*, 107 IOWA L. REV. 941, 968 (2021) (discussing the unviability of appraisal waivers in the firm's charter).

[105] See, e.g., Klaassen v. Allegro Dev. Corp., No. CV 8626-VCL, 2013 WL 5739680, at *24 (Del. Ch. Oct. 11, 2013) (finding that the DGCL's mandatory rules apply to the corporate charter, but not to shareholder agreements).

[106] Cf. Manti Holdings, LLC v. Authentix Acquisition Co., Inc., 2021 WL 4165159, at *48 (Del. Sept. 13, 2021) (concluding that public policy concerns do "not prohibit sophisticated and informed stockholders from voluntarily waiving their appraisal rights in exchange for valuable consideration.").

[107] Id. at 37 (reiterating previous case law according to which "… [t]here is no utility in defining as forbidden any term thought advantageous to informed parties, unless the term violates substantive law."). See also Abry Prs V, L.P. v. F&W Acq. LLC, 891 A.2d 1032, 1061-62 (Del. Ch. 2006) (acknoweledging that "[the Court] respects the ability of sophisticated businesses […] to make their own judgments about the risk they should bear" and stressing that "the common law ought to be especially chary about relieving sophisticated business entities of the burden of freely negotiated contracts"). The duty of loyalty is the main exception. See Welch & Saunders, *supra* note 98, at 859-60. In the case law, see In re Good Tech. Corp. Stockholder Litig., No. 11580-VCL, 2017 WL 2537347, at *4 (Del. Ch. May 12, 2017) (suggesting that a court might refuse to enforce a drag-along clause if the board violates its fiduciary duties in approving the applicable transaction). But more recently see New Enterprises Associates 14, L.P., et al. v. George S. Rich, Sr., et al., A.3d, 2023 WL 3195927, at *129 (Del. Ch. May 2, 2023) (concluding that Delaware corporate law authorizes a shareholder-specific, contractual waiver only when it is narrowly tailored to apply to a specific transaction that would otherwise constitute a fiduciary breach and where the waiver satisfies a review for reasonableness).

been challenged, courts have so far always confirmed the enforceability of the relevant contractual arrangements,[108] except for one isolated instance in which private ordering arguably sought to accomplish "extreme" results,[109] that the Delaware legislature immediately declared legitimate by amending the DGCL, thus defending the domain of unfettered private ordering against anomalous judicial intervention.[110]

Furthermore, in administering Delaware corporate law, courts typically refrain from deploying one-size-fits-all gap-filling tools. Instead, when reviewing purported opportunism, Delaware courts apply fiduciary standards in a way that adapts them to the fundamental economic rationale of specific contracts,[111] including the arrangements found in VC deals.[112] And while the *Trados* doctrine has provided a conspicuous but short-lived exception to this long-standing tradition,[113] courts have recently reaffirmed that contracting parties have broad

[108] In re Appraisal of Ford Holdings, Inc. Preferred Stock, 698 A.2d 973 (Del. Ch. 1997) (confirming the validity of an arrangement in the firm's charter imposing a cap on the price that preferred shareholders would receive by exercising their appraisal rights). On appraisal waivers see also the case law cited *supra* note 106. Alarm.com Holdings, Inc. v. ABS Capital Partners, Inc. No. CV- 2017-0583-JTL, 2018 WL 3006118 (Del. Ch. June 15, 2018) (upholding broad corporate opportunity doctrine waivers, if crafted in non-generic terms).

[109] Solutions that would have had the practical effect of depriving the board of its core function are the only known example. See West Palm Beach Firefighters' Pension Fund v. Moelis & Co., No. 2023-0309-JTL (Del. Ch. Feb. 23, 2024) (invalidating a small number of provisions in an unusual shareholder agreement assigning extremely broad veto rights to a shareholder).

[110] See, e.g., Mark Lebovitch, *The Drama Around Moelis and New DGCL Section 122(18) Just Got Hotter*, CLS BLUE SKY BLOG, Nov. 18, 2024, at https://clsbluesky.law.columbia.edu/2024/11/18/the-drama-around-moelis-and-new-dgcl-section-12218-just-got-hotter/.

[111] See, e.g., Bergman & Nicolaievsky, *supra* note 48, 740 ("U.S. investor protection contracts employ inexplicit restrictions on firm actions that seem to rely on the courts' aptitude to enforce them judiciously in order to fulfil their protective purpose in a way that would not have been possible had those contracts … been restricted to consider only simple, explicit contingencies.").

[112] See Orban v. Field, No. 12820, 1997 Del. Ch. LEXIS 48 (Apr. 1, 1997); and Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997). The literature has explained that the "control-contingent approach" as resulting by the joint reading of the decisions taken in *Orban* and *Equity-linked* represents the Delaware court's attempt to adapt the operation of the duty of loyalty to the peculiarities of VC-backed startups. Under that case law, control of the board enables venture capitalists or the entrepreneur to take actions that are inimical to the other party, provided that they can be defended as being in the best interest of the firm. See Jessie M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L.REV. 968, 990-93 (2006).

[113] The so-called "Trados doctrine" stems chiefly from *In re Trados, Inc.*, 73 A.3d 17, 40–41 (Del. Ch. 2013), but has been confirmed in other instances, such as in the decision issued in *Frederic Hsu Living Trust v. ODN Holding Corporation* C.A. No. 12108-VCL (Del. Ch., April 14, 2017). The doctrine states that directors should aim to maximize *common* shareholder value if the interests of common shareholders and preferred shareholders conflict in VC-backed firms. This approach hinders venture capitalists' exercise of their rights, particularly when it comes to executing trade sales and redemptions. It thus indirectly hampers contractual freedom in VC deals. Unsurprisingly, the *Trados* doctrine has attracted much criticism, particularly for failing to take the specificities of VC-backed firms into account. See, e.g., William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, 161 U. PA. L. REV. 1815, 1885 and 1893 (2013)(outlining the problematic aspects of the *Trados* doctrine and stressing the potentially adverse implications for VC deals); Robert P. Bartlett III, *Shareholder Wealth Maximization as Means to an End*, 38 SEATTLE UNIV. L.R. 25, 286-95 (2015) (criticizing *Trados* for marking the culmination of Delaware courts' inclination to erroneously confuse shareholder wealth maximization as a means to maximize firm value with shareholder wealth maximization as an end in itself and for failing to appreciate the board's dynamic role of gap-filler of an incomplete contract and thus forcing contracting parties to specify ex ante future contingencies); Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 215-18 (2019) (arguing, *inter alia*, that *Trados* erred in bringing in a homogeneous vision of loyalty for all corporate directors and may adversely affect VC financing). Building on interviews with lawyers, Abraham Cable had concluded that *Trados*

discretion in shaping the duty of loyalty,[114] thereby empowering market participants to define what qualifies as abuse. In other words, VC contracts can stipulate that, in specific instances, venture capitalists can make ex post inefficient decisions.[115]

At the same time, Delaware corporate law tackles abuse effectively, as Delaware courts complement Delaware corporate law's deference to private ordering. Instead of reviewing the validity of contractual arrangements, they police the relevant agents' *behavior* under the contract,[116] especially through fiduciary standards.[117] This approach helps remedy the ex post opportunistic behavior in line with the contract's economic rationale as reflected (also) in its implied terms.[118] Judicial reports provide many examples of how prohibiting abuse relies on context-specific determinations of what constitutes inadmissible behavior.[119]

In short, under Delaware corporate law, private ordering enjoys a wide latitude[120] and courts generally respect negotiated solutions.[121] Complex prescriptive rules and standards are largely absent and, therefore, legal uncertainty about what private ordering can achieve is significantly reduced. Courts are aware of this feature.[122] True, isolated shocks can still

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did not matter that much. See Abraham Cable, *Does Trados Matter?*, 45 J. CORP. L. 311 (2020). More recent empirical evidence confirms that this case law has had an adverse effect on the U.S. VC market, though. See Bian, Li, & Nigro, *supra* note 95.

[114] See New Enterprises Associates 14, L.P., et al. v. George S. Rich, Sr., et al., *supra* note 107, at 129.

[115] The case law cited *supra* note 114 implies that a venture capitalist who induces the board to sell the VC-backed firm for less than its stand-alone value is not necessarily subject to the fairness test.

[116] Case law has stressed the complementarity between the latitude of the space for private ordering in shaping the firm's governance and the strict adherence of contracting parties to fiduciary standards in implementing the resulting arrangements. See, e.g., Williams v. Geier, 671 A.2d 1368, 1381 (Del. 1996) ("At its core, the [DGCL] is a broad enabling act which leaves latitude for substantial private ordering, provided the statutory parameters and judicially imposed principles of fiduciary duty are honored"), followed most recently by Salzberg v. Sciabacucchi, 227 A.3d 102, 116 (Del. 2020) and CCSB Fin. Corp. v. Totta, No. 424, 2022, 2023 WL 4628822, at *8 (Del. July 19, 2023). In the literature, see, e.g., Coffee, *The Mandatory / Enabling Balance in Corporate Law: An Essay on the Judicial Role* (1989) 89 COLUM. L.R. 1618, 1620 (noting that courts' deferential approach to private ordering comes along a strong inclination to police opportunism).

[117] Charles M. Yablon, *On the Allocation of Burdens of Proof in Corporate Law: An Essay on Fairness and Fuzzy Sets*, 13 CARDOZO L. REV. 497, 502 (1991) ("if the terms of the underlying transaction stink badly enough, the courts will find a way to abrogate any procedural protections supplied by the business judgment rule").

[118] Coffee, *supra* note 116, at 1620 ("… to the extent that American courts have permitted greater contractual freedom in corporate law, their relative tolerance has been coupled with greater judicial activism in reading implied terms into the corporate contract ….."). See also *supra* note 111.

[119] *Basho Technologies Holdco B LLC v. Georgetown Basho Investors LLC*, C.A. No. 11802-VCL (Del. Ch. July 6, 2018) (ordering the venture capitalist, who had failed to meet the burden of proof under the entire fairness test, to pay damages to the entrepreneur for having, *inter alia*, repeatedly levered on its veto rights to prevent the VC-backed firm from carrying out a critical recapitalization, ultimately forcing the company into liquidation with the intention of purchasing its assets at a low price).

[120] See *supra* note 103, as well as the case law cited in note 107.

[121] Cf. Robert B. Thompson, *Why New Corporate Law Arises - Implications for the Twenty-first Century*, *in* THE CORPORATE CONTRACT IN CHANGING TIMES. IS THE LAW KEEPING UP? (Steven D. Solomon & Randall S. Thomas eds. 2019), 3, at 3 (emphasizing that, as the twenty-first century approached, "[s]tate law abandoned its prior regulatory approach and its continual change in favor of a director-centric structure with expansive room for private ordering that has remained remarkably stable.").

[122] Cf., e.g., *Ascension Ins. Hldgs., LLC v. Underwood*, 2015 WL 356002 (Del. Ch. Jan. 28, 2015), at *4 ("[Delaware corporate law] respects the right of parties to freely contract and to be able to rely on the enforceability of their agreements; where Delaware's law applies, with very limited exceptions, our courts will enforce the

materialize. Yet, the essential hallmark of Delaware corporate law remains: courts generally neither second-guess the validity or enforceability of contractual arrangements nor interpret them in ways that may hinder contracting parties' ability to exercise the ensuing rights consistently with the economic logic of the agreement.

2. U.S. venture capital contracts: functions and features

In conjunction with the National Venture Capital Association's standardization efforts and startup lawyers' creativity,[123] Delaware corporate law has enabled venture capitalists and entrepreneurs to elaborate and refine a set of complex, highly standardized private ordering arrangements to regulate their relationship.[124]

A vast literature has described the individual components of this contractual framework,[125] which pursues two primary goals. First, VC contractual arrangements address the severe uncertainty, information asymmetries, and moral hazard that characterize the funding of highly innovative projects.[126] These problems are responsible for, *inter alia*, the largely asymmetric nature of the VC-backed firm's financial structure and the significant exit penalty a misbehaving entrepreneur must pay.[127]

Second, the private ordering solutions included in U.S. VC contracts are instrumental to aligning VC-backed firms' lifecycles with the organizational and operational features of VC

contractual scheme that the parties have arrived at through their own self-ordering, both in recognition of a right to self-order and to *promote certainty of obligations and benefits*.")

[123] The NCVA drafts the "Model Legal Documents," a set of standard contracts that serves as the starting point for negotiations between venture capitalists and entrepreneurs. In preparing these model legal documents, the NCVA is driven, *inter alia*, by the ambition to "[a]nticipate and eliminate traps for unenforceable or unworkable provisions." See *Model Legal Documents*, NAT'L VENTURE CAP. ASS'N, *https://nvca.org/model-legal-documents* (accounting for the purposes of the model legal documents). Lawyers have also played an important supportive role in this process. See John F. Coyle & Joseph M. Green, *Startup Lawyering 2.0*, 95 N.C. L. REV. 1403, 1412-15 (2017), and, for some empirical evidence, Bartlett, *supra* note 90, at 27-29.

[124] See, e.g., Brian Broughman, Jesse Fried, & Darian Ibrahim, *Delaware Law as Lingua Franca: Theory and Evidence*, 57 J.L. & ECON. 865 (2014) (documenting empirically that startups Delaware corporate law's flexibility is one main reason why VC-backed firms incorporate in Delaware). See also See Eldar, Grennan & Waldock, *supra* note 95, 560 (reporting the results of a survey according to which one important reason for incorporating in Delaware consists in the "expertise of Delaware's judiciary on business law issues."). On the complexity of such contracts see THERESE H. MAYNARD & DANA M. WARREN, BUSINESS PLANNING: FINANCING THE START-UP BUSINESS AND VENTURE CAPITAL FINANCING (3d ed. 2014), at 638. See also Robert P. Bartlett III, *Standardization and Innovation in Venture Capital Contracting: Evidence from Startup Company Charters* (Rock Center for Corporate Governance at Stanford University Working Paper No. 253, 2023), *https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4568695*, at 24-25 (documenting that by the end of 2022 nearly 85% of the newly incorporated VC-backed firms had charters that reflected the NVCA standard contractual form). Standardization obviously does not imply that VC contracting is immune to innovation. See, *id.* at 30-38.

[125] See, e.g., Gilson, *supra* note 8, at 1078-85, and Klausner & Litvak, *supra* note 8, at 59-66 (both discussing chiefly stage financing, convertible preferred shares, and redemption rights).

[126] See generally Lerner, *supra* note 32, 406-09.

[127] Steven N. Kaplan & Per Strömberg, *Characteristics, Contracts, and Actions: Evidence from Venture Capitalist Analyses*, 59 J. FIN. 2177, 2195-2203 (2005).

funds.[128] In fact, they enable VC funds to support inter-firm information flows and thus facilitate the creation of synergies among portfolio companies[129] and inter-firm alliances.[130] Key to this are arrangements that grant venture capitalists discretion in both allocating business opportunities across portfolio companies[131] and terminating one investment to benefit another.[132]

Finally, since venture capitalists invest with a view to cashing out (at the latest) before the VC fund is wound down,[133] U.S. VC contracts include contractual arrangements that, after an initial lock-in of venture capitalists and entrepreneurs into their partnership, enable venture capitalists to acquire control over exit decisions.[134]

Reflecting these two goals, four core features characterize the contractual framework governing VC deals in the U.S. First, these contracts allocate cash-flow and control rights separately,[135] allowing venture capitalists to rely on control rights that are often largely disproportionate to their equity stake.[136] Crucially, that enables venture capitalists to acquire minority interests in portfolio companies, enhancing their ability to diversify their funds' portfolios.[137]

Second, such contracts shape venture capitalists' and entrepreneurs' cash-flow and control rights as "state-contingent,"[138] which is key for venture capitalists to respond to relevant changes.[139] For instance, contracts enable venture capitalists to seize board control or

[128] Gilson, *supra* note 8, at 1091 (showing how the structure of "the two contracts [is] intertwined, each operating to provide an implicit term that supports the other, and thereby increasing the contractual efficiency of both").

[129] See Juanita González-Uribe, *Exchanges of Innovation Resources inside Venture Capital Portfolios*, 135 J. FIN. ECON. 144 (2020) (finding that exchanges of resources between portfolio companies increase by an average of 60% over the sample mean relative to exchanges between them and matched non-portfolio companies and that, as a result, returns to innovation in VC portfolios are higher than those of innovative firms that are not backed by VC).

[130] See, e.g., Laura Lindsey, *Blurring Firm Boundaries: The Role of Venture Capital in Strategic Alliances*, 63 J. FIN. 1137 (2008) (finding that venture capitalists act as facilitators of value-creating alliances between portfolio firms that would not emerge without a common investor due to information problems).

[131] Eldar, Grennan & Waldock, *supra* note 95, at 576 and 560-61 (finding that the adoption of corporate opportunity waivers benefits startups in many ways and that these arrangements are virtually ubiquitous in U.S. VC deals).

[132] Xuelin Li, Tong Liu, & Lucian A. Taylor, *Common Ownership and Innovation Efficiency*, 147 J. FIN. ECON. 475 (2023).

[133] See *supra*, notes 27-29 and accompanying text.

[134] D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 318-37 (2005). Board control is key to initiating exit transactions. See Fried & Ganor, *supra* note 112, at 987 & n.55. In fact, empirical evidence shows that venture capitalists are more often in control as VC-backed firms mature. See Michael Ewens & Nadya Malenko, *Board Dynamics over the Startup Life Cycle* 27 (ECGI – Finance Working Paper No. 687/2020, 2020), *https://ssrn.com/abstract=3640898*.

[135] Steven Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 281 (2003).

[136] See *supra* note 37.

[137] See Lerner & Schoar, *supra* note 5, at 226.

[138] See Kaplan & Strömberg, *supra* note 135, at 281-82 and 287-91 (showing that the dependence of cash-flow and control rights' allocation on firm performance is a key feature of VC contracts).

[139] Wei Wang & Chris Yung, *Employment Protection and Venture Capital Investment: The Impact of Wrongful Discharge Laws*, MGMT. SC. (forthcoming 2025) (discussing how contractual arrangements, such as

otherwise advance their agenda (for instance by replacing the CEO[140]), whether under specific circumstances, such as the firm's bad performance, or close to the time of divestment.[141]

Third, U.S. VC contracts include a so-called termination option that enables VC funds to exit underperforming firms.[142] In fact, if the firm fails to achieve a robust growth trajectory, the venture capitalist can swiftly seize control and direct the company towards divestment transactions, such as redemptions and trade sales, that primarily serve venture capitalists' interests and result in an uneven distribution of firm value.[143] This termination option is indicative of the logic underpinning U.S. VC contracts, which maximize value for contracting parties *ex ante* at the price of legitimizing value-decreasing decisions *ex post*.[144] That is part of the deal: sophisticated investors can well agree on contractual solutions that, *ex post*, depart from the goal of maximizing value under each and any circumstances.[145] Although the resulting transactions may appear to be opportunistic *ex post*,[146], they just reflect the incentive structure and risk allocation parties not only agreed upon *ex ante* but also priced.[147] Defining what constitutes an abusive exercise of the rights ensuing from these contracts accordingly requires an in-depth inquiry into the rationale of the entire contractual framework and the circumstances under which parties have acted.[148]

Fourth, these contracts include powerful "carrot-and-stick" provisions,[149] which generously reward successful entrepreneurs while harshly punishing non-performing ones.

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those enabling venture capitalists to terminate the entrepreneur's employment, are crucial to enable them to exploit real options and showing how rigid labor laws curtailing those contractual arrangements stifle VC investments).

[140] For details, see Hellmann, *supra* note 7.

[141] See *supra* note 134 for references.

[142] See Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309, 1331 (2008) (highlighting that, under the standard U.S. VC deal, the venture capitalist has the right to terminate the investments if the firm performs poorly) and 1328-1333 (arguing that courts should not stand in the way of venture capitalists deciding when to pull the plug on a struggling company). The termination option also allow VC funds to meet their liquidity needs when the they near their end. See Bratton & Wachter, *supra* note 113, 1885 (2013). This is crucial to enable venture capitalists to deliver on the promises made to their own investors in a timely manner and support the VC financing model. See Casimiro A. Nigro & Jorg R. Stahl, *Venture Capital-Backed Firms, Unavoidable Value-Destroying Trade Sales, and Fair Value Protections*, 22 EUR. BUS. ORG. L. REV. 39, 64-65 (2021).

[143] Swift changes in control rights allocation are possible because of the state-contingent nature of contracting parties' rights and duties. See *supra* notes 138-141 and accompanying text. An uneven allocation of firm value is possible because of the firm's asymmetric financial structure, which is in turn due to so-called liquidation preferences. See *infra* Part III.B.3.b.iii.

[144] See generally Baird & Henderson, *supra* note 142, at 1314.

[145] Granting senior investors the right to decide on firm termination, generally through bankruptcy filing, and letting them obtain a disproportionate share of firm value under certain circumstances may be mutually beneficial because it provides founders with strong incentives to avoid those adverse circumstances. See *id*.

[146] *Id*. at 1314 (explaining that value-destroying transactions may appear as opportunistic instances of self-dealing, but stressing that sophisticated, fully informed parties might nevertheless agree on such terms *ex ante*).

[147] See Bratton & Wachter, *supra* note 113, at 1893 (noting that "'[f]airness' in the venture capital context cannot be determined by taking a snapshot of the board that approved [a given transaction] … The causal chain needs to be considered in the wider transactional context.").

[148] See Nigro & Stahl, *supra* note 142, at 64-65 (explaining that, under U.S. VC contracts, value-destruction does not necessarily postulate the abusive exercise of a given contractual right).

[149] For examples, see Broughman & Fried, *supra* note 20, at 1335-1355 (discussing this carrot-and-stick approach as regards the divestment process).

Taken together, these mechanisms shape an "all-or-nothing governance structure"[150] relying on self-enforcing mechanisms.[151] Their synergetic interplay enhances efficiency because carrot-and-stick provisions adjust venture capitalists' rights based on predetermined parameters and events[152] and the agreed-upon terms can be enforced with minimal reliance on external adjudication.[153] This enables venture capitalists to save time and resources[154] and minimizes the reputational risk associated with litigation.[155]

3. The presumptive efficiency of U.S. venture capital contracts

Theoretical and empirical research supports the claim that the U.S. contractual framework represents the most efficient/best available real-world solution to the fundamental private ordering challenges that venture capitalist and entrepreneurs face when defining the terms of their business relationship.[156] The literature has shown not only that its components reduce market frictions,[157] but also that real-world transactional practice closely aligns with financial

[150] Cf. Bratton & Wachter, *supra* note 113, at 1885 (explaining that "[t]his all-or-nothing governance framework presumably yields a highly incentivized entrepreneur.").

[151] See, e.g., Maria Isabel Sáez Lacave & Nuria Bermejo Gutiérrez, *Specific Investments, Opportunism and Corporate Contracts: A Theory of Tag-along and Drag-along Clauses*, 11 EUR. BUS. ORG. L. REV. 423, 439-40 (2010) (presenting drag-along and tag-along provisions as self-enforcing contractual devices). On the various ways in which self-enforcement plays out in this context, see *supra*, note 87.

[152] Cf., e.g., Bartlett, *supra*, note 43, at 80 (explaining how U.S. venture capitalists secure protection from economic dilution through so-called antidilution provisions and providing an example of how these provisions rely on conversion rights and their conversion ratio to deliver an automatic adjustment of the protection for venture capitalists).

[153] See Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006) (outlining how contract drafting can make formal enforcement unnecessary).

[154] Speedy enforcement is key to the venture capitalist-entrepreneur relationship. The VC industry operates under the pressure stemming from the cyclicality of its business model, with a view to realizing investments within a given timeframe. See *supra* note 29 and accompanying text. The ability to rely on timely contractual implementation, including through self-enforcement and, less frequently, enforcement actions where appropriate, is thus a critical factor to stay in business. For details, see MAYNARD & WARREN, *supra* note 124, at 688 (noting, when discussing the contractual arrangements that guarantee the self-enforcement of drag along right provisions, that "[t]his bit of self-help is recognition that resort to the courts, even an action for injunctive relief, in order to enforce internal corporate procedure is slow and expensive" and that this calls for special private ordering solutions "giving the company and the [venture capitalist] a mechanism to move forward" promptly).

[155] See Vladimir Atanasov, Vladimir Ivanov, & Kate Litvak, *Does Reputation Limit Opportunistic Behavior in the VC Industry? Evidence from Litigation against VCs*, 67 J. FIN. 2215, 2218 (2012) (providing empirical evidence of reputational losses for venture capitalists involved in litigation).

[156] Cf. Lerner & Schoar, *supra* note 5, at 224 (explaining that "an extensive theoretical literature suggests that [U.S. contracts] are a second-best solution to contracting in private equity."). Research has reached similar conclusions for many of the specific components of the relevant contractual framework. See, e.g., Phillippe Aghion & Patrick Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 77 REV. ECON. STUD. 338 (1992) (developing a model that shows that convertible preferred shares are one of the best real-world solutions to obviate market frictions by allocating control contingent on a given signal).

[157] Kaplan & Stromberg, *supra* note 135, *passim*.

contracting theory.[158] Moreover, it has remained largely stable over time and across industries[159] and has emerged more recently as the contractual underpinning of startup-financing outside the VC industry.[160]

The claim about the efficiency of U.S. VC contracts ultimately hinges on the absence of material transaction costs that prevent venture capitalists and entrepreneurs from entering into a Coasian bargain.[161] The available empirical evidence suggests that VC deals under the U.S. contractual framework create value in equilibrium, particularly if this framework is used by high-quality venture capitalists. To be sure, asymmetric bargaining power may lead to contractual structures of individual deals that do not maximize joint surplus.[162] Yet, it stands to reason that arrangements facilitating one contracting party's ruthless rent-seeking would not be stable over time. The intuition is that the party with a stronger bargaining position will leave money on the table if they do not offer terms that maximize joint value.[163] Therefore, non-exploitative arrangements are also in the long-term best interest of venture capitalists, who can learn over time how to structure their contractual relationships accordingly. This is not to say that each and every individual transaction reflects an optimal contractual design. Similarly, ex post opportunism can occur in individual cases.[164] Yet, the combination of contracting parties' mutual interest to arrange their relationship efficiently and venture capitalists' reputational concerns should effectively curb it.[165]

In line with the idea that U.S.-style VC contracts are the most efficient, best available real-world solution to the problems associated with financing innovation,[166] financial

[158] Kaplan & Strömberg, *supra* note 135, at 297-305 (exploring the conformity of VC real-world contracts to financial contracting theories). See also *supra* notes 30-42 and accompanying text (discussing the key efficiency rationales and characteristics of VC contracts).

[159] See Kaplan & Strömberg, *supra* note 135, at 286-95 (documenting empirically the homogeneity in contracting patterns over time in their sample). The legal literature has reached similar conclusions regarding specific components of VC contracts. See, e.g., Fried & Ganor, *supra* note 112, at 981-83 and 1015 (describing VC-backed firms' financial structure and governance arrangements shaped chiefly through convertible preferred shares and director appointment rights and characterising them as persisting over time, respectively).

[160] Sergey Chernenko, Josh Lerner, & Yao Zeng, *Mutual Funds as Venture Capitalists? Evidence from Unicorns*, 34 REV. FIN. STUD. 2362 (2021) (documenting that the contractual technology deployed by mutual funds investing in start-ups is largely similar to the VC one).

[161] See generally Coase, *supra* note 77.

[162] See Michael Ewens, Alexander S. Gorbenko, & Arthur Korteweg, *Venture Capital Contracts*, 143 J. FIN. ECON. 131 (2022) (providing empirical evidence that venture capitalists use their bargaining power to negotiate rent-seeking terms but also showing that the resulting deal structures are not value-destroying).

[163] See, e.g., BARRY NALEBUFF, SPLIT THE PIE: A RADICAL NEW WAY TO NEGOTIATE 19-28 (2022).

[164] See, e.g., Gilson, *supra* note 8, at 1085 (noting that "[r]educing the agency costs of the entrepreneur's discretion by transferring it to the venture capital fund also transfers to the fund… the opportunity to use that discretion opportunistically against the entrepreneur.").

[165] Reputation plays a crucial role in constraining venture capitalists' misbehavior. C.N.V. Krishnan & Ronald Masulis, *Venture Capital Reputation*, *in* THE OXFORD HANDBOOK OF VENTURE CAPITAL 61 (Douglas J. Cummings, ed., 2012). Empirical evidence shows that venture capitalists abstain from acting opportunistically even when it would be easy for them to do so. For instance, venture capitalists who have already extended financing to a given firm could take advantage of their insider information to use follow-on "inside" financing rounds at artificially low valuations to dilute entrepreneurs. Yet, they typically do not and instead often use these transactions to provide entrepreneurs with backstop financing at relatively high valuations, "perhaps to reduce litigation risk" and thus avoid any ensuing adverse effect on their reputation. See Brian J. Broughman & Jesse M. Fried, *Do VCs Use Inside Rounds to Dilute Founders? Some evidence from Silicon Valley*, 18 J. CORP. FIN. 1104 (2012).

[166] See *supra* Part III.A.2.

economists have documented that venture capitalists and entrepreneurs in other jurisdictions tend to replicate them.[167] Contracting parties outside the U.S. have progressively switched from locally peculiar contractual arrangements to U.S.-style ones, with a positive effect on VC firms' survival rates.[168] Yet, transplanting U.S.-style VC contracts into other jurisdictions may prove difficult or even impossible,[169] as anecdotes from the law and finance literature suggest.[170] The next Section delves into the thickets of such transplanting exercises and scrutinizes how German and Italian corporate laws affect VC contracts.

B. Constrained Private Ordering in Germany and Italy

In this Section, we show that German and Italian corporate laws stand in the way of venture capitalists' and entrepreneurs' ambition to achieve the efficient allocation of control and cash-flow rights available in U.S. VC deals—whether by transplanting verbatim U.S. VC contracts' individual components or resorting to functionally equivalent solutions. These two corporate law regimes are taken to be two examples of corporate law that depart significantly from our pro-VC corporate law paradigm[171] and exhibit the features of a rigid corporate law that impede efficient VC contracting.[172] We are aware that each component of U.S. VC contracts has a specific weight in the economy of the deal.[173] Therefore, rather than limiting our analysis to a potentially self-serving selection of individual VC contract clauses, one of our companion papers analyzes the regulatory constraints under German and Italian corporate laws in action systematically and comprehensively shows how they prevent contracting parties from allocating cash-flow and control rights in a way that is functionally equivalent to the presumptively efficient U.S. VC contract model.[174] Here, we build on that analysis and provide some illustrations that showcase the adverse impact of German and Italian corporate laws on efficient VC contracting.

Before doing so in Section 3, though, we explain why contracting parties in Germany and Italy cannot circumvent local corporate laws' strictures, explain how we distill German and Italian corporate laws in action, and describe the general features of these two corporate law regimes to spotlight their adverse stance to private ordering in general and VC contracting in particular (Section 1). We then provide an overview of how German and Italian corporate laws frustrate venture capitalists' and entrepreneurs' ambitions to transplant the individual

[167] See, e.g., Lerner & Schoar, *supra* note 5, at 226.

[168] See Kaplan, Martel, & Strömberg, *supra* note 23, at 276 (noting that "[a]ll of the funds in our sample that used both non-US and US style contracts at some point, switched from non-US to US style during the sample period"); and 304 (providing data confirming that the use of key U.S.-style contractual solutions is associated with higher survival rates among VC firms).

[169] See Lerner & Schoar, *supra* note 5, at 226.

[170] One such anecdote is that a private equity firm that had tried to replicate private ordering solutions that are typical of U.S. VC deals in Peru found itself unable to enforce them, which led it to switch to simpler solutions key local players were more familiar with. *Id.*, at 227-28.

[171] See *supra* Part II.C.1

[172] See *supra* Part II.C.3.

[173] Paul A. Gompers, Will Gornall, Steven N. Kaplan, & Iliav A. Strebulaev, *How Do Venture Capitalists Make Decisions?*, 135 J. FIN. ECON. 169 (2020) (documenting empirically the greater importance of some provisions).

[174] See Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12.

components of U.S. VC contracts or devise functional equivalent solutions and leave them with no option other than deploying inferior alternative arrangements (Section 2).

1. German and Italian corporate laws

In this Section, we explain why domestic corporate laws matter for German and Italian VC deals despite the room for regulatory arbitrage that characterizes, *to some extent*, corporate law in the two jurisdictions we focus on (Section a). Next, we describe how we distill corporate law in action to assess the viability of the various components of U.S VC contracts in the two jurisdictions (Section b). Finally, we provide information about German and Italian corporate laws' adverse stance to private ordering in general and VC contracting in particular (Section c).

a. The illusory promise of corporate law arbitrage

For most VC-backed businesses to be run in Germany and Italy, domestic corporate law is the legal product of choice.[175]

As we discuss more in detail in a companion paper, incorporating in another E.U. jurisdiction is *de facto* an unattractive option.[176] Despite *Centros* and its progeny of cases,[177] which have acknowledged E.U. incorporators' right to choose the applicable corporate law regime by registering their company in any member state, the choice of foreign corporate law does not fully insulate companies from domestic corporate law.[178] Courts of the jurisdiction where the foreign-incorporated company has its central administration may indeed apply certain domestic corporate law requirements to it. As a result, incorporating in other E.U. member states results in higher costs of dealing with an alien jurisdiction, without excluding the risk that the corporate law requirements contracting parties seek to escape from will nonetheless apply.[179]

Incorporating in Delaware, which in principle is also an option,[180] creates similar frictions.[181] Finally, venture capitalists and entrepreneurs cannot resort to even more complex but at least equally costly arrangements, such as so-called "dual structure companies", to bypass local corporate law's strictures either.[182]

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[175] See Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part II.A.1.

[176] Id.

[177] See 1999 E.C.R. *Centros Ltd v Erhvervsog Selskabsstyrelsen.*

[178] See Enriques, Nigro, & Tröger, *The Shadow of Mandatory Corporate Law*, *supra* note 26, Part II.A.1.

[179] Id.

[180] See Treaty of Friendship, Commerce, and Navigation, United States-West Germany, Oct. 29, 1954, 7 U.S.T. 1839; and Treaty of Friendship, Commerce, and Navigation, United States-Italy, Feb. 2, 1948, 63 Stat. 2255.

[181] See Enriques, Nigro, & Tröger, *The Shadow of Mandatory Corporate Law*, *supra* note 26, Part II.A.1.

[182] *Id.* Part II.A.2.

These observations explain why, to the best of our knowledge,[183] most VC-backed firms based in Germany and Italy, and especially those at an early stage, are incorporated under local corporate laws.[184]

b. Distilling corporate law in action

To find out whether U.S.-style VC-contracts can be successfully transplanted into Germany and Italy, we need to assess the various clauses typically used in U.S. VC deals against—not just corporate law on the books, but—corporate law in action.[185]

Note that, unlike in the U.S.,[186] German and Italian corporate law in action does not simply coincide with judge-made corporate law. Multiple players—including notaries and, above all, scholars—play a critical role in shaping it.[187] Thus, we define corporate law in action as the set of pertinent (private law) rules as interpreted by German and Italian courts, legal scholars, and practitioners. The relevant law in action is that which applies to the *Aktiengesellschaft* ("AG") and the *Gesellschaft mit beschränkter Haftung* ("GmbH") in Germany and the *Società per azioni* ("Spa") and the *Società a responsabilità limitata* ("Srl") in Italy because most VC backed firms use these organizational forms.[188] Our definition of corporate law in action includes also those explicit and implicit rules that are formally part of German and Italian contract law but bear on what private ordering can achieve in the corporate context.[189]

We distill the relevant German and Italian corporate law in action as follows. If there is pertinent, well-established case law, we look exclusively at it. If there is no case law, or if the exact meaning of the relevant judgments is unclear, we extend our analysis to doctrinal legal scholarship and other authoritative sources that bear on the interpretation of corporate law—such as the guidelines on the interpretation of corporate law issued by the regional association

[183] Exchanges with legal practitioners have confirmed our claim.

[184] See Enriques, Nigro, & Tröger, *The Shadow of Mandatory Corporate Law*, *supra* note 26, Part II.A.1.

[185] See *supra*, Part II.C.1, especially the text accompanying notes 70-73.

[186] See *supra*, text accompanying note 186.

[187] See *infra*, Part III.1.c.

[188] German corporate law codifies the regime applicable to firms organized as AGs and GmbHs in two distinct statutes. See Aktiengesetz [AktG] [Stock Corporation Act], Sept. 6, 1965, BUNDESGESETZBLATT I [BGBI I] at 1089, last amended by Gesetz [G], Feb. 22, 2023, BGBI I at 51; and Gesetz betreffend die Gesellschaften mit beschränkter Haftung [GmbHG] [Act on Limited Liability Companies]. Italian corporate law is mainly located in the Codice Civile [C.c].

[189] Corporations have a contractual basis both in Germany and Italy. As to Germany, see Andreas Pentz, *§ 23 para. 10*, *in* MÜNCHENER KOMMENTAR ZUM AKTG - VOL. 1 (Wulf Goette & Mathias Habersack eds., 6th ed. 2024) (organizational contract *sui generis*). As to Italy, corporations' contractual nature is the function of explicit statutory provisions. See Codice civile [C.c.], art. 2247 (It.). Case law and scholars alike have acknowledged this ever since. See Cassazione sezione civile (Cass. civ.), 26 ottobre 1995, n. 11151 (It.); Mario Libertini, *Ancora in tema di contratto, impresa e società. Un commento a Francesco Denozza, in difesa dello "istituzionalismo debole"*, 40 GIURISPRUDENZA COMMERCIALE 1 (2014). Therefore, in both jurisdictions, general contract law applies, however adapted to account for the nature of the corporate contract, which does not govern a spot exchange, but creates an organization.

of notaries in Italy.[190] In these instances, corporate law in action is the interpretation of existing legal texts that is predominant among legal scholars and practitioners at the time of our writing—even though we acknowledge that both practitioners and courts may occasionally deviate from a majority view in legal scholarship. If differing views on a specific legal issue exist, we weight the strength of the conflicting positions to identify the view that courts are most likely to adopt and acknowledge uncertainty where such a prediction cannot be reasonably made. This approach introduces an element of discretion in our analysis that, however, cannot be avoided.

c. General traits

German and Italian corporate laws are strongly averse to private ordering. They depart significantly from the pro-VC corporate law paradigm[191] and exhibit the features of a rigid corporate law framework inhibiting efficient VC contracting.[192] The aversion to private ordering we document for these jurisdictions is the outcome of the extensive use of their metarules to create mandatory rules and standards in addition to those resulting from blackletter law.[193]

Scholars in both jurisdictions conceive corporate law as a set of explicit and implicit rules and standards and see themselves in charge of developing a consistent legal (sub-)system. This leads to a continued expansion of mandatory corporate law.[194] German and Italian legal gatekeepers—namely corporate counselors and notaries—and especially courts and arbitrators share scholars' methodological canons and legal culture and, therefore, tend to endorse academics' prevailing views and interpretations, considering doctrinal scholarship as particularly authoritative.[195] The resulting skepticism towards private ordering is particularly pronounced if those arrangements (1) shape investors' position in the firm as a hybrid between debt and equity; (2) may directly or indirectly harm creditors' interests; (3) are supported by self-enforcing mechanisms that bypass judicial review and are thus often seen as inherently prone to abuse; (4) appear unbalanced at first glance and thus appeal to courts' and scholars' proclivity to sympathize with the "weak" or "aggrieved" contracting party.[196] Note that scholars, practitioners, courts, and arbitrators often use vague equitable justifications to rationalize their interference with contractual arrangements and legitimize "fair" outcomes *ex*

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[190] In Italy, local notarial associations periodically publish guidelines that should guide notaries in interpreting corporate law when discharging their duties. The Milan notarial association is the most influential. For details see Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part II.C.

[191] See *supra* Part II.C.1.

[192] See *supra* Part II.C.3.

[193] This phenomenon, which is deeply rooted in the two countries' legal culture, explains why reforms aimed at making corporate law friendlier to private ordering in both Germany and Italy did not have much of an impact. See Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part II.C; Enriques, Nigro, & Tröger, *The Shadow of Mandatory Corporate Law*, *supra* note 26, Part III.A.

[194] For details and references, see Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part II.C.

[195] For details and references, see Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part II.C.

[196] *Id.*

post, without considering the disruptions their intervention brings to *ex ante* fair and efficient arrangements.[197]

More specifically, a number of general, high-level requirements—sometimes explicitly mentioned in blackletter law and often finding their source in scholarly interpretations, practitioners' guidelines, or courts' opinions—are used to set aside private ordering solutions. These requirements include the doctrine of unconscionability, anti-avoidance rules,[198] the special protection of property rights under constitutional law, and the legal capital doctrine.[199] From them rules and standards are derived that often have a broad scope and apply to the relevant contractual arrangements irrespective of: (i) whether these are located in the firm's charter or in shareholder agreements;[200] (ii) the transaction's legal form;[201] and (iii) the sophistication of contracting parties.[202]

Moreover, under German and Italian corporate laws, ex post gap-filling tools—like the "duty of good faith"[203]— are largely mandatory and hardly adapted to the economics of individual cases. Therefore they fail to complete arrangements in a way tailored to the VC contracts' transactional objectives.[204] Together with the focus on ex post "fair" outcomes[205]

[197] *Id.*

[198] German law relies on an uncodified evasion doctrine that leads to the immediate application of the circumvented provision and thereby effectively voids any bypassing arrangements that contracting parties may have envisioned. For details, see Susanne Sieker, UMGEHUNGSGESCHÄFTE, Tübingen: Mohr Siebeck, 2001, at 8-45. Under Italian law, any contract or clause that constitutes the means of evading a mandatory provision is void. See Article 1344 of the ICC. For details, see, e.g., GIUSEPPE CRICENTI, I CONTRATTI IN FRODE ALLA LEGGE 7-47 (2nd ed., 2008).

[199] Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part II.C and Part III.C.

[200] Under German law, scholars and courts explicitly acknowledge in several instances that resorting to shareholder agreements does not increase the leeway for private ordering. For details, see Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part II.C. In Italy, there is a widespread conviction among both Italian scholars and courts that shareholder agreements cannot bypass mandatory corporate law. See, e.g., Carlo F. Giampaolino, *Clausole di trascinamento (c.d. drag along): "equa" determinazione del valore vs. valorizzazione*, 12 RIVISTA ORIZZONTI DEL DIRITTO COMMERCIALE 230, at 233 (2024); and Corte di Cassazione, 18 July 2008, n. 15963.

[201] For an example, see *infra*, Part III.B.3.b.i. (discussing how Italian corporate law treats bad leaver provisions).

[202] For an example, see Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part II.C.

[203] For details, see *Id*.

[204] The directors' fiduciary duty of loyalty under Italian corporate law is construed as implying the duty to advance the interest of the firm and applies irrespective of any company's individual characteristics. The duty of loyalty of widely held companies' directors is therefore the same as that of close corporations, and, *a fortiori*, no variations exist between the duty of loyalty of the directors of a close corporation running a family business and that of directors of a VC-backed firm. See, e.g., Alberto Mazzoni, *Patti di co-vendita e doveri fiduciari in* TRASFERIMENTI DI PARTECIPAZIONI AZIONARIE (Alberto Crivellaro ed, 2017), 211, at 245-249 (explaining that a shareholder must always pursue the interest of the shareholders as a class, irrespective of a specific firm's financial structure and governance and the content of (implicit) contractual arrangements). See also Gian Domenico Mosco & Casimiro A. Nigro, *I doveri fiduciari alla prova del capitalismo finanziario* (2021) 20 ANALISI GIURIDICA DELL'ECONOMIA 257 (pointing out that the lack of nuances reneges on the VC specific alignment of interests laid down in the contract the venture capitalist and the entrepreneur concluded).

[205] See generally *supra* note 197.

these gap filling doctrines facilitate qualifying transactions as opportunistic despite venture capitalists' and entrepreneurs' original expectations to the contrary.

The unpredictable emergence of new rules and standards under German and Italian corporate law threatens to thwart contractual contingency arrangements in an unanticipated manner and, therefore, creates extreme legal uncertainty that devalues VC contracts.[206]

2. Contractual transplants? No, thanks!

Under German and Italian corporate laws venture capitalists and entrepreneurs do not enjoy much room for the complex private ordering exercise underpinning efficient VC contracting. Table 1 below summarizes the findings of our companion paper's systematic analysis of the transplantability of the individual components of U.S. VC contracts.[207] We classify individual components as either *viable* or *unviable* under German and Italian corporate laws. Viable means that the relevant corporate law either does not preclude the transplant of a specific component of U.S. VC contracts *or* permits functionally equivalent solutions. Unviable, by contrast, means that the constraints stemming from German and Italian corporate laws impede the adoption and use of one of those individual components *and* their functionally equivalent solutions. In the latter case, German and Italian corporate laws may allow for the adoption of inferior alternative arrangements or even bar such arrangements altogether.[208]

Table 1. Synopsis of the viability of U.S.-style VC contracts' provisions under German and Italian corporate law

Contractual Provision	Description	German Law	Italian Law
Staged Financing	Venture capitalist has the right to provide capital contingent on the startup achieving specific milestones.	Unviable. inferior alternative arrangements ("IAAs") are available.	Unviable. IAAs are available.
Conversion Rights	Venture capitalist has the right to convert their shares into common shares at a predetermined conversion ratio.	Unviable. IAAs are available.	Unviable. IAAs are available.
Liquidation Preferences	Venture capitalist has the right to receive payment of a predetermined amount before common shareholders.	Unviable. IAAs are available.	Unviable. IAAs are available.

[206] See *supra* Part II.C.3.b.

[207] Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part III.C.

[208] For the distinction between "alternative arrangements" and "functionally equivalent solutions," see *supra* text accompanying notes 80-81.

Automatic & Cumulative Dividends	Venture capitalist has the right to receive automatic remuneration of their investments regardless of profits and the right to have unpaid dividends accrued.	Unviable. IAAs are unavailable.	Unviable. IAAs are unavailable.
Anti-dilution Provisions	Venture capitalist has the right to have conversion ratios automatically adjusted if new shares are issued at a lower valuation than their initial investment.	Unviable. IAAs are available.	Unviable. IAAs are available.
Director Appointment & Removal Rights	Venture capitalist has the right to appoint or remove board members.	Unviable. IAAs are available.	Unviable. IAAs are available.
Protective Provisions	Venture capitalist has control over certain major business decisions to protect their investment and/or influence strategic directions.	Unviable. IAAs are available.	Unviable. IAAs are available.
Corporate Opportunity Doctrine Waivers	Venture capitalists (*qua* controlling shareholders) and directors appointed by, or affiliated with, the venture capitalist are exempt from liability for breaching the corporate opportunity doctrine.	Viable if GmbH form is chosen. .	Unviable. IAAs are available.
Share Transfer Restrictions	Limits entrepreneurs' ability to sell their shares thus enabling venture capitalists to maintain control over the firm's ownership structure.	Unviable. IAAs are available.	Unviable. IAAs are available.
Bad Leaver Provisions	Specifies that entrepreneurs who leave under certain negative conditions shall have their shares repurchased at a punitive price.	Unviable. IAAs are available.	Unviable. IAAs are available.
Tag-along Rights	Venture capitalists can sell their shares along those of the entrepreneur if the latter sells their equity.	Viable.	Viable.
Drag-along Rights	Venture capitalist can compel entrepreneurs to sell their shares to a third party in a share co-transfer.	Unviable. IAAs are available.	Unviable. IAAs are available.
Fair Value Protection Waivers	Compels the entrepreneur to approve a merger and thereby lose their appraisal right.	Unviable. IAAs are unavailable.	Unviable. IAAs are unavailable.
Fiduciary Duty Waivers	Precludes the entrepreneur from suing the venture capitalist and/or the directors appointed by or affiliated with the venture capitalist for breaches of the duty of loyalty in transactions consummated in the (sole) interest of the venture capitalist.	Unviable. IAAs are unavailable.	Unviable. IAAs are unavailable.

Redemption Rights	Venture capitalists can have their shares repurchased by the company at a predetermined price.	Unviable. IAAs solutions are available.	Unviable. IAAs solutions are available.

In short, German and Italian corporate laws thwart venture capitalists' and entrepreneurs' ambition to allocate cash-flow and control rights comparably to U.S. VC contracts, as they rule out *almost* all individual components of the U.S. contractual framework and preclude functionally equivalent solutions.

3. Illustrations

We now draw on the treatment applicable to exemplary provisions of U.S. VC contracts under German and Italian corporate law to showcase how venture capitalists and entrepreneurs are prevented from transplanting U.S. VC contracts or adopting functionally equivalent solutions. Our illustrations draw from the systematic, in-depth analysis of one of our companion papers.[209]

a. Absolute prohibitions: automatic and cumulative dividends

German and Italian corporate laws include several relative prohibitions that ban not only the transplant of U.S.-style arrangements and their functionally equivalent solutions but also any alternative arrangement.[210] The regime applicable to the U.S.-style arrangements for automatic and cumulative dividends exemplifies this approach.

U.S. VC deals typically grant venture capitalists the right to receive automatic and cumulative dividends. Such dividends mature regardless of whether the firm is profitable and require no specific deliberation by the company's competent bodies. If—as is commonly the case—the VC-backed firm does not generate revenues and thus fails to distribute dividends in the due amount, any such unpaid dividends will accrue to the nominal value of liquidation preferences,[211] thus cumulating over time and becoming payable only following a liquidity event. Automatic and cumulative dividends provide an interest-like time-value-of-money adjustment of venture capitalists' liquidation preferences. They strengthen the downside protection that venture capitalists typically enjoy in U.S. VC deals.

For very similar reasons, automatic and cumulative dividends are subject to an absolute prohibition under both German and Italian corporate laws.[212]

First, in both Germany and Italy, shareholders necessarily contribute to the firm's equity, which is represented by shares that must incorporate a residual claim to future cash-flows. These cash-flows, in turn, are inherently linked to the firm's fortunes. Shareholders may thus receive dividends only out of profits. Scholars infer from this characterization of the

[209] See Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12.

[210] See *supra*, Part II.C.3.a.

[211] On these see *infra* Part III.B.3.b.iii.

[212] See Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part_III.C.1.iv, also for references.

shareholders' position that any arrangement introducing an element of certainty into the remuneration of equity investments is alien to their inherently uncertain nature.

Furthermore, there are obstacles stemming from positive corporate law's explicit provisions and doctrines. In Germany, the regime governing AGs includes a prohibition of contractual "commitments to pay interests to shareholders," which scholars unanimously interpret as applicable to any arrangements that grant a shareholder a right to receive a fixed remuneration of their equity investment, including those regarding automatic dividends. More generally, German and Italian corporate law ultimately prohibit dividend payouts that do not result from realized profits or dissolved reserves. As a consequence, no contractual arrangement can ensure that the venture capitalist will receive automatic dividends, independent of the venture's financial condition.

In addition, both German and Italian corporate laws impose procedural obstacles. In essence, dividends can only be paid out after shareholders approve the annual accounts and resolve on the allocation of any surplus. Where organizational law provides more leeway, as it happens under the regime for closed corporations, dividend payouts still require ad hoc shareholder involvement. Therefore, arrangements granting venture capitalists the right to receive automatic dividends are also procedurally unviable.

The requirement under German and Italian corporate laws that dividend distribution be contingent on profits also rules out cumulative dividends. Although corporate law in both jurisdictions does not explicitly ban such arrangements, companies can only distribute cumulative dividends if they have a sufficient surplus covering cumulative dividend claims.

Consistent with the absolute nature of the prohibition on automatic and cumulative dividends, the regimes described above apply to any arrangement that grants shareholders the right to have their equity investment remunerated independent of firm performance—irrespective of its design and of whether it is located in the firm's charter or in shareholder agreements. Thus, not only does it rule out the transplant of U.S.-style contractual arrangements, but it also thwarts the adoption of any functionally equivalent solutions and even of any hypothetical inferior alternative arrangements.

b. Relative prohibitions

German and Italian corporate laws include several relative prohibitions that ban efficient U.S.-style arrangements and functionally equivalent solutions. Contracting parties can only devise inferior alternative arrangements.

i. Prohibition by addition: bad leaver provisions

In some instances, German and Italian corporate laws compel venture capitalists and entrepreneurs to add "strings" to U.S.-style contractual arrangements. These additional restrictions often allow dissatisfied parties to challenge the contractual arrangement or the other party's exercise of contractual rights in court.[213] Bad leaver provisions are a notable example.[214]

[213] See *supra*, Part II.C.3.a.

[214] See Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part III.C.2.vi, also for references.

Consider that venture capitalists cannot fully assess the personal qualities of the entrepreneur before they invest. After the investment, the entrepreneur may opportunistically take advantage of their controlling position within the VC-backed firm or otherwise jeopardize their cooperation with the venture capitalist through grossly negligent or self-serving behavior. U.S. VC contracts mitigate this problem, *inter alia*, via bad leaver provisions included in the firm's charter. These provisions grant the VC-backed firm and/or the venture capitalist the right to buy the entrepreneur's shares at punitive conditions in case of misbehavior such as fraud, gross misconduct, or overstepping the limits of authority. Such provisions act as an effective, self-enforcing arrangement to discipline opportunistic or negligent entrepreneurs.

German and Italian corporate laws prevent contracting parties from adopting U.S.-style bad leaver provisions. To be sure, depending on the firm's organizational form, German and Italian corporate laws allow contracting parties to adopt arrangements that entitle the VC-backed firm and/or the venture capitalist to redeem the entrepreneur's shares. Yet, these arrangements are subject to several constraints that impair their smooth, unchallenged operation and thereby render them inferior to their U.S. model.

The most important constraint implies that venture capitalists cannot force entrepreneurs to dispose of their shares at a price lower than fair value. German corporate law stipulates that the price at which venture capitalists can buy out misbehaving entrepreneurs is subject to a judicial assessment of its fairness. Italian corporate law achieves the same result by limiting contractual freedom *ex ante*. Any contractual arrangement causing the expulsion of a shareholder must make a formal reference to a minimum price. The floor price must be determined in accordance with legally prescribed criteria under the "fair value principle."

This regime applies also to other contractual arrangements, such as buy-sell provisions, that cause one shareholder to divest upon another shareholder's decision. That is, the regime implies a general ban on any functionally equivalent solutions. Contracting parties can only resort to inferior alternative arrangements that, although drafted in a way similar or even identical to the equivalent U.S. provisions, are less functional and thus ultimately inapt to serve as effective, self-enforcing tools to discipline opportunistic or negligent entrepreneurs.

ii. Mandated relocation: redemption rights

In other cases, German and Italian corporate laws compel parties to relocate contractual solutions that in U.S. VC deals feature in the firm's charter to shareholder agreements.[215] The starkest example comes from redemption rights under Italian corporate law.[216]

Redemption rights, which in U.S. VC deals appear in the firm's charter, entitle venture capitalists to have their shares bought back by the VC-backed firm, typically after five years from the date of the initial investment. Redemption rights provide venture capitalists with an easy-to-activate downside protection in case the VC-backed firm underperforms, enabling them to recover the remaining value of their shares while saving on opportunity costs if the firm can neither go public nor find a buyer. Even more importantly, redemption rights give venture capitalists leverage vis-à-vis the entrepreneur: by threatening the exercise of their rights, which could bankrupt the VC-backed firm, the venture capitalist can discipline the entrepreneur,

[215] See *supra* Part II.C.2.a.

[216] See Enriques, Nigro, & Tröger, *Can U.S. Venture Capital Contracts Be Transplanted*, *supra* note 12, Part III.C.3.ii, also for references.

particularly in the run-up to a trade sale. Redemption rights mitigate moral hazard by making entrepreneurs' defection and opportunism less likely.

In U.S. VC deals, redemption rights are also complemented with so-called voting switch provisions, which make sure that, contingent on the circumstances, venture capitalists can seize formal board control in a variety of "default events," which include also the non-payment of the amount due in the event of redemption. This is crucial for the venture capitalist's ability to self-enforce its redemption right, because the venture capitalist can take actions (for instance, selling the firm's crown jewels) that produce the cash required to liquidate the venture capitalist's shares.

Italian corporate law prevents venture capitalists from including redemption rights vis-à-vis the firm in the corporate charter. The best (inferior) alternative is to insert the latter clause in a shareholder agreement. Yet, the resulting put option would lack the benefits of complementary self-execution tools found in U.S. VC contracts. The redeeming transaction would in fact have to be entered into between the venture capitalist and the entrepreneur. Therefore, a venture capitalist willing to enforce their redemption right would have to start a lengthy judicial proceeding against a likely cash-constrained entrepreneur—facing both high costs and the prospect of realizing little or nothing.

Despite sharing the same name as their U.S. counterparts, the redemption rights that appear in Italian VC deals fail to serve any of the functions that justify their inclusion in VC contracts.

iii. Fairness review: liquidation preferences and director appointment and removal rights

In further instances, German and Italian corporate laws introduce regulatory constraints that enable courts to check the fairness of (a) the terms of a given arrangement and/or (b) the exercise of the ensuing right.[217]

(a) The regime governing so-called liquidation preferences under both German and Italian corporate laws exemplifies the first type of constraint aimed at preserving the fairness of the terms of the VC contract.

U.S. VC-backed firms' charters include liquidation preferences—that is, a senior financial claim for an amount equal to the original investment or a multiple thereof. These claims establish a hierarchy for the distribution of the proceeds in liquidity events—such as redemptions, trade sales, or the company's winding up. Liquidation preferences can be either participating or non-participating, depending on whether venture capitalists share in the proceeds of a sale on a *pro rata* basis with the common shareholders after receiving the value of their liquidation preferences, on top of their fixed claim. These liquidation preferences increase over time because of the arrangements on automatic and cumulative dividends. Liquidation preferences exhibit important efficiency properties: by compelling entrepreneurs to face longer odds of a positive return, they allow them to credibly signal their own beliefs regarding their managerial skills, personal determination, and the quality of the project. This facilitates venture capitalists' task of screening out low-quality investment opportunities. In addition, liquidation preferences mitigate entrepreneurs' appetite for risk-taking and private

[217] *See supra*, Part II.C.3.a.

benefit extraction at the firm's expense and motivate them to implement the business project with optimal effort.

German and Italian corporate laws do not allow for plain liquidation preferences, because the "size" of the venture capitalist's preferential cash-flow rights is subject to judicial review, which creates uncertainty as to whether the liquidiation preferences will be upheld.

Under German corporate law, scholars advocate an *ex post* judicial review because *participating* liquidation preferences enable the venture capitalist to capture a disproportionate amount of firm value as both a fixed and a residual claimant, potentially leading to unfair outcomes for the entrepreneur. The doctrine scholars invoke to justify such a review is rooted in the general concept of good faith. Good faith commands a contracting party to consider the interests of the other party in performing their obligations and exercising their rights, to ensure that each of them achieves their transactional objectives. Given that, in exit scenarios involving coasting or close-to-failing firms, liquidation preferences can lead the venture capitalist to receive the bulk, if not all, of a liquidity event's proceeds, entrepreneurs may look like the victims of a full-blown expropriation strategy. Subjecting liquidation preferences to the good faith test aims at remedying such expropriation by allowing judges to review the terms of the divestment transaction.

Under Italian corporate law, arrangements mimicking U.S. liquidation preferences may be held to violate the wide-ranging ban of so-called "giraffine pacts." Such pacts are arrangements that prevent certain shareholders from sharing in the firm's profits by making the firm's equity structure look like a tall shrub with leaves only at the top on which solely the long-necked giraffe can browse. The greater the preferential rights the venture capitalist receives according to the VC contract, the greater the chances that the liquidation preferences will be held to be prohibited giraffine pacts.

The trouble is that there is simply no way of defining liquidation preferences *ex ante* in a way that ensures that the entrepreneur "gets at least something" while preserving the core function of liquidation preferences. An entrepreneur who receives little or nothing as a result of a liquidity event can threaten the venture capitalist with litigation. With their vague standards aiming, German and Italian corporate laws encourage this type of litigation, making German and Italian liquidation preferences no more than a shadow of the U.S. model.

(b) The regime governing directors appointment and removal rights under German corporate law exemplifies the second type of constraints, namely standards enabling courts to interfere with the exercise of the rights stipulated in the VC contract.

Several features of the VC-backed firm make it prone to mismanagement by entrepreneurs who frequently have little to no previous business and managerial experience. Moreover, as the business project develops, conflicts of interests between venture capitalists and entrepreneurs multiply and entrepreneurs who control the board may take actions detrimental to the venture capitalist. To minimize the risk of *ex post* rent-seeking on the entrepreneur's part, venture capitalists are vested with significant decision-making power, particularly through board representation: specific provisions in U.S. VC-backed firms' charters typically grant venture capitalists the right to appoint and remove directors, which they can exercise with broad discretion.

German corporate law, with due variations between the AG and the GmbH, allows contracting parties to adopt arrangements that vest venture capitalists with the right to appoint and remove directors. Yet, it also stipulates that, in removing directors, venture capitalists bear fiduciary obligations that imply that they have to exercise their removal rights in the interest of the corporation and consider other shareholders' company-related interests adequately. This enables entrepreneurs to litigate any "selfish" decision venture capitalists allegedly take. This looming judicial intervention may deter venture capitalists from exercising the rights they have bargained for as they would find appropriate, decreasing the functionality of venture capitalists' prerogatives significantly.

Nor can venture capitalists and entrepreneurs devise arrangements that may serve as effective substitutes. In U.S. VC deals, specific arrangements grant venture capitalists the right to appoint so-called board observers, however, not as a substitute but as an addition to board appointment and removal rights. Such observers have no voting rights and are thus unable to steer the firm's operations, lacking the essential powers of venture capitalist-appointed corporate directors. Including the relevant arrangements in German VC deals would not help bypass critical constraints on director appointment and removal rights.

iv. Loss of synergies: conversion rights and anti-dilution provisions

In further instances, German and Italian corporate laws create cascade effects because the constraints against adopting a specific element of the U.S. VC contractual framework also adversely impacts the functionality of related contractual arrangements.[218] Conversion rights are a case in point: their unavailability also affects the availability of U.S.-style anti-dilution provisions, compelling contracting parties to use inferior alternative arrangements.

U.S.-style conversion rights enable the venture capitalist to respond to the changes in a highly uncertain environment. Depending on firm performance, their financial claims morph from fixed into residual ones. Anti-dilution provisions aim to mitigate the risk of dilution in so-called down rounds—that is, the infusion of additional equity at a share price lower than that previously paid by the venture capitalist. Anti-dilution provisions protection hinges crucially on the conversion rights of the venture capitalist's convertible preferred shares. If the firm issues or commits to issuing additional shares at a price below the then-current conversion price of convertible preferred shares, the conversion ratio of the venture capitalist's convertible preferred shares is automatically adjusted to the price of the newly issued shares, preserving their original effect through a self-enforcing mechanism.

Conversion rights are, however, off-limits under both German and Italian corporate law because they clash with key characteristics of the corporate form and share ownership as construed in doctrinal legal scholarship and relevant case law. The unavailability of U.S.-style conversion rights has important indirect consequences because it also eliminates the basis for anti-dilution provisions. Venture capitalists and entrepreneurs bargaining under German and Italian corporate laws, therefore, must address economic dilution risk through inferior alternative arrangements. These arrangements typically grant the venture capitalist the right to acquire the additional shares required to preserve their position in the firm in a capital increase.

Not only are such inferior alternative arrangements of uncertain validity, but they also entail an increase in costs and a significant loss in functionality compared to U.S. model clauses, if only because managing economic dilution risk with such arrangements requires the firm to go through an additional new share issuance for the benefit of the "old" venture capitalist.

[218] See *supra*, Part II.C.3.a.

c. Extreme legal uncertainty: drag-along rights provisions

Uncertainty is another constraint on efficient VC contracting from rigid corporate laws.[219] And German and Italian corporate laws are loaded with uncertainty: what the exact corporate regime is and how it will evolve is largely unpredictable, particularly when corporate law is interpreted to assess the validity of innovative, "foreign" contractual arrangements.[220] Venture capitalists and entrepreneurs negotiating their deals in Germany and Italy must, therefore, regularly factor in the risk that the arrangements they adopt may eventually prove invalid or that, when exercising the ensuing rights, they will suddenly have to conform to newly crafted standards of conduct that do not adhere to the economic rationale of their agreements. The Italian case law on drag-along provisions provides tangible evidence of how extreme legal uncertainty can affect VC contracting in practice.

Venture capitalists need to divest in order to deliver on the promises they made to their investors. In contrast, driven by their idiosyncratic vision and/or aversion to losing their firm-specific human capital investments, entrepreneurs may prefer continuation even when winding down or selling the business would maximize the venture capitalist's and the entrepreneur's joint payouts. Entrepreneurs may also strategically (threaten to) delay a sale to extract a higher price for their shares in a hold-up of venture capitalists. U.S. VC contracts respond to the prospective resistance of entrepreneurs against trade sales, *inter alia*, by providing for drag-along rights in shareholder agreements. Drag-along right provisions allow the venture capitalist to transfer full control of the VC-backed firm to a third-party acquirer without any objection from the entrepreneur, who can neither block the transaction nor challenge the allocation of its proceeds. To this end, they define the behavior that the venture capitalist and the entrepreneur shall observe in a trade sale. If the trade sale takes the form of a merger, the entrepreneur shall vote their shares as the venture capitalist instructs—thus approving the transaction and simultaneously losing their appraisal right. If the trade sale takes the form of a share transfer, the venture capitalist shall have the right to transfer the entrepreneur's shares to a *bona fide* acquirer of their own shares under the same terms and conditions, including the price.

Italian corporate law precludes arrangements that grant venture capitalists similar discretion in executing trade sales. In Italy, mergers have never been attractive for executing a trade sale, because cash-for-stock mergers are not permitted, while stock-for-stock mergers prevent venture capitalists from realizing their investment in cash. As a result, Italian VC contracts adopt U.S.-style drag-along provisions only to assign venture capitalists the right to sell the entrepreneur's shares along with their own.

Since the early 1990s, VC deals in Italy relied on a contractual framework that included U.S.-style drag-along clauses. In the late 2000s, however, an entrepreneur challenged the legality of a drag-along clause. In court, the plaintiff invoked several implicit mandatory corporate law provisions, including the fair value principle, allegedly making such a contractual arrangement illegal. Under the influence of notaries, who issued a specific guideline on the matter, and a prominent scholar who acted as the plaintiffs' consultant, the court endorsed the plaintiffs' view that the drag-along right clause should have included a floor referencing the fair price as determined in accordance with the fair value principle. Due to the absence of such a floor, the court invalidated the provision. The financier was ultimately unable to unilaterally carry out the exit transaction the parties had negotiated.

[219] See supra, Part II.C.3.b.
[220] See *supra*, Part III.B.1.c.

The crucial implicit corporate law constraint had remained "hidden" in scholarly work without surfacing in any prior case law and was only strategically rediscovered by the plaintiff to renege on the original bargain. The hardly anticipated outcome illustrates the extreme legal uncertainty that looms pervasively in a rigid corporate law system with metarules that allow to foil private ordering efforts.

C. A Transatlantic Functional Gap

We have showed that venture capitalists and entrepreneurs in the U.S. have leveraged Delaware corporate law's flexibility to create a sophisticated contractual framework for venture capital deals. Economic theory recognizes this framework as something close to the optimal solution to the challenges inherent in financing high-tech firms.[221] Functionally speaking, not only does that contractual framework mitigate the market frictions that bedevil startup financing, but it also braids the contract governing the VC-backed firm with the organizational and operational features of the VC fund.[222]

We have also showed how rigid German and Italian corporate laws prevent venture capitalists and entrepreneurs from achieving comparable results in defining the governance of German and Italian VC deals. While we offer only limited examples here, we provide substantial evidence that both corporate law regimes systematically clash with contracting parties' ambition to maximize joint value through private ordering in related work.[223] The functional deficiencies of each individual component of German and Italian VC deals in turn leads to a significant functional gap between the contractual technologies governing VC deals on the two shores of the Atlantic that affects the key functions of VC contracts. The contractual framework governing German and Italian VC deals performs its essential functions less effectively than its U.S. counterpart. On the one hand, it is less apt to mitigate market frictions. For instance, the contractual arrangements responsible for adopting an asymmetric financial structure are not credible, as they are *de facto* renegotiable. An entrepreneur who receives little or nothing as a result of a liquidity event sale can threaten the venture capitalist with litigation and force a renegotiation of the *ex ante* agreed-upon terms determining the allocation of the firm's risk and the overall financing conditions of the deal.[224] Empirical evidence shows that, if the applicable legal regimes allow for strategic litigation, entrepreneurs challenge the allocation of firm value after divestment transactions in the courtroom.[225] Consistent with this, research shows that in civil law countries liquidation preferences are typically smaller than liquidation preferences in U.S. VC deals,[226] indicating contracting parties' efforts to accept suboptimal arrangements to avoid litigation. Thus, private ordering fails to engineer solutions

221 See *supra*, Part III.A.1-3.

222 See *supra*, text accompanying notes 126-134.

223 See Enriques, Nigro and Tröger, *Can U.S. Venture Capital Contracts Be Transplanted into Europe?*, *supra* note 12, *passim*.

224 *Cf.* Bratton & Wachter, *supra* note 113, at 1888-89 (explaining that pro-common shareholder fiduciary standards, such as those forged by the *Trados* doctrine (on which see *supra* note 113), enable entrepreneurs to litigate virtually any transaction carried out by the venture capitalist).

225 Broughman & Fried, *supra*, note 28.

226 See Kaplan, Strömberg, & Martel, *supra* note 23.

that perform its ex ante screening and its ex post incentivizing functions as effectively as in the U.S.

On the other hand, braiding similarly operates less effectively than in the U.S., because corporate law requirements and extreme uncertainty weaken the essential contractual arrangements venture capitalists depend on for divestment. As Douglas Cumming and coauthors have noted, "where laws impact exit, they also impact the decision to invest and therefore the entire development of a [VC] market."[227]

The contractual framework governing German and Italian VC deals is nothing but a shadow of the U.S. role model. First, venture capitalists must resort to larger equity stakes because the contractual allocation of cash-flow and control rights is constrained, which entails lower portfolio diversification than in the U.S.[228] Second, while venture capitalists are granted the right to terminate the firm, they cannot rely on U.S.-style contractual solutions to appropriate the residual firm value.[229] Third, as German and Italian corporate laws, rather than contract, draw a line between legitimate and abusive conduct, VC contracts lose their filtering properties,[230] generating severe problems of under- and over-inclusiveness that distort VC deals' logic.[231] Fourth, German and Italian corporate laws compel parties to enter VC deals delivering "fair" outcomes for all parties instead of the all-or-nothing terms of U.S. VC deals. Additionally, the sticks that venture capitalists can use in the U.S. to punish misbehaving entrepreneurs become palm leafs once transplanted into German and Italian VC deals.[232] Finally, self-enforcement mechanisms tend to be unavailable.[233] Consequently, the automatic implementation processes characterizing U.S. VC agreements are lost,[234] and judicial intervention in the execution of negotiated deals becomes standard practice. This not only disrupts the business relationship between entrepreneurs and venture capitalists but may also endanger the smooth implementation of the VC investing process and damage venture capitalists' reputation in the market.[235]

In sum, venture capitalists and entrepreneurs negotiating within the constraints of German and Italian mandatory corporate law inevitably create contractual frameworks with substantial functional deficiencies. At the margin, mandatory law is therefore bound to influence VC deal-making and, arguably, the size of VC markets.[236]

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[227] Douglas Cumming, Grant Fleming, & Armin Schwienbacher, *Legality and Venture Capital Exits*, 12 J. CORP. FIN. 214, 216 (2006). For empirical evidence, see Bian, Li, & Nigro, *supra* note 93 (documening how changes in the regime defining the discretion venture capitalists enjoy in executing divestment transactions can affect startups' access to finance).

[228] See *supra*, note 135-137 and accompanying text.

[229] See *supra*, note 142-148 and accompanying text.

[230] For the definition of "filtering contracts," see *supra* note 62. For an application to U.S. VC contracts, see *supra* text accompanying note 83.

[231] See *supra* Part III.B.3.b.iii.

[232] See *supra* Part III.B.3.i.

[233] For how we conceptualize self-enforcement in this context, see *supra* Part II.C.3.a.

[234] See *supra* Part III.B.3.iv.

[235] On the importance of both, see *supra* notes 154 and 155 and accompanying text.

[236] See *supra* II.C.2.

IV. CONCLUSION

VC is a key driver of innovation and economic growth. Policymakers have, therefore, repeatedly sought to encourage VC investments, including in Europe. Although an extensive literature has shed light on the correlation between a number of institutional variables and VC investments, including corporate law, it has thus far failed to gain a holistic understanding of the exact ways in which corporate law affects VC contracting.

This Article contributes to filling this gap. It has refined and enriched the theory that corporate law matters for VC contracting because of its relative rigidity or flexibility. It presents a novel transaction cost-based framework, reveals the various channels through which rigid corporate law hampers efficient VC contracting, and explains how these constraints penetrate into transactional practice and affect VC deal-making. To test that theory, we have compared and contrasted the ways in which venture capitalists and entrepreneurs bargain in real-world corporate law environments with enabeling and constraining features, namely Delaware's, on the one hand, and Germany's and Italy's, on the other. We have shown how the constraints stemming from German and Italian corporate laws prevent venture capitalists and entrepreneurs in Germany and Italy from mimicking the U.S. contractual framework or devising functionally equivalent solutions, compelling them to use alternative arrangements that, when available, are less functional than the corresponding arrangements in U.S. VC deals. This leads to a significant functional gap between the contractual technologies governing VC deals on the two shores of the Atlantic. The bottom line is that a rigid corporate law entails efficiency losses that may curb the vibrancy of VC markets.

While we have focused on German and Italian corporate laws, our analytical framework can be used to shed light on the corporate law-VC contracting nexus in any other jurisdiction.

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