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

Luca Enriques, Casimiro A. Nigro, and Tobias H. Tröger

Global Corporate Governance Colloquia 2025

Imperial College, London

June 13, 2025

LEIBNIZ INSTITUTE SAFE

Sustainable Architecture for Finance in Europe

Overview

- **Research question:** Does corporate law prevent efficient VC contracting in non-U.S. jurisdictions?
  - Interrelation of VC markets and the institutions of corporate law and governance
  - Rigid corporate law (in action) as pivotal constraint on private ordering
  - Restrictive legal technologies (“channels”)
  - Examples from German and Italian corporate laws
  - A glimpse at the policy implications

US & EU VC markets

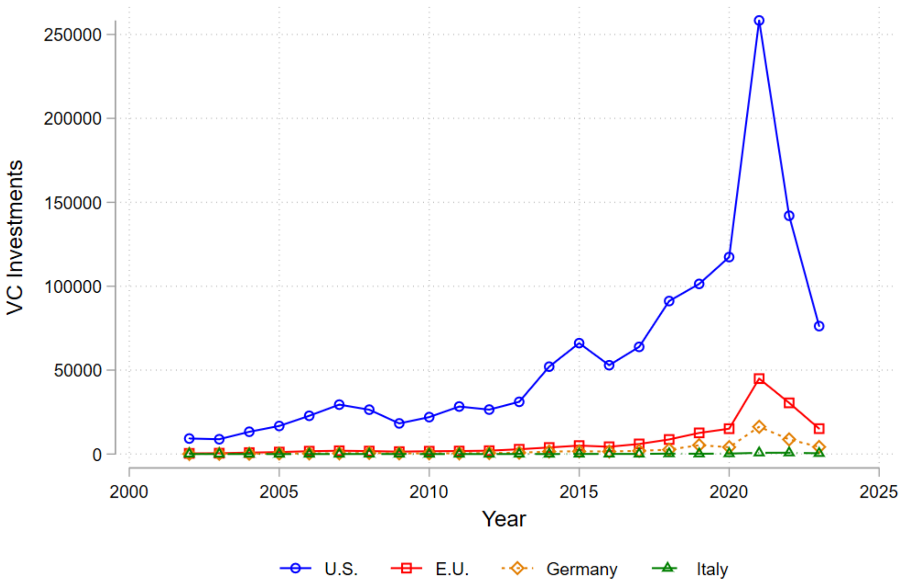

FIGURE 1. VC investments (seed up to L-Series) in the U.S., the E.U., Germany, and Italy 2002-2023 (in USD million). Data source: *Preqin*, 2024.

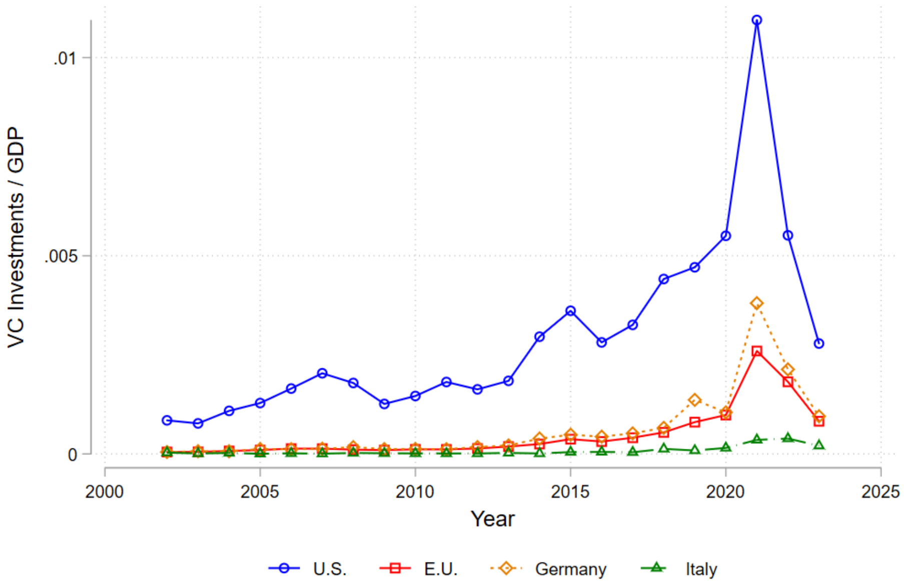

FIGURE 2. VC investments (seed up to L-Series) in the U.S., the E.U., Germany, and Italy 2002-2023 scaled to GDP (in USD million).
Data sources: *Preqin*, 2024; *World Bank*, 2024.

US & EU VC deals

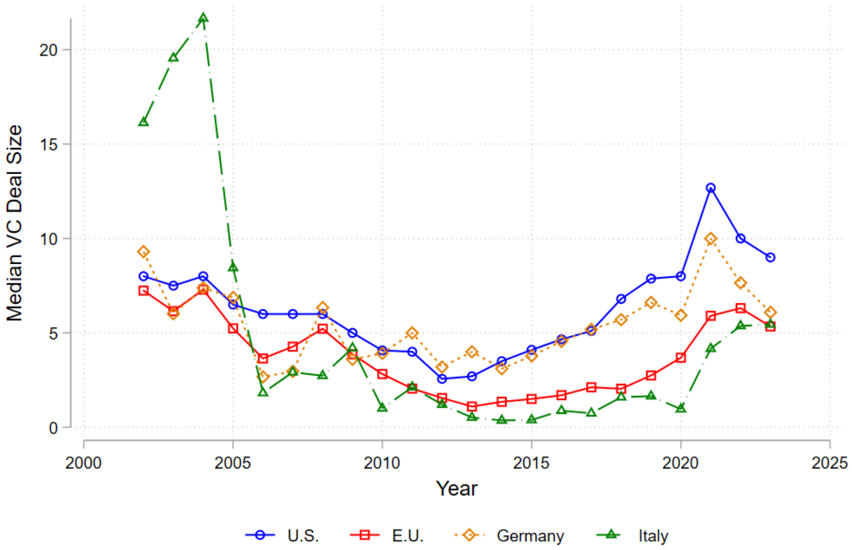

FIGURE 3. Median size of VC deals (seed up to L-Series) in the U.S., the E.U., Germany, and Italy 2002-2023 (in USD million). Data source: *Preqin*, 2024

VC and institutions: the irrelevance view

- Vast literature on interrelation of institutional environment and VC markets, including influence of corporate law, e.g., Allen and Song (2003), Lerner and Schoar (2005)
- Kaplan et al. (2007)
  - "…analyze how the contracts allocate cash flow, board, liquidation, and other control rights.
  - and find "[i]n univariate analyses, contracts differ across legal regimes. US style contracts are more typical in common law countries. However, there appear to be few institutional impediments to implementing US style terms. More experienced VCs are able to implement US style contracts regardless of legal regime."
- Private ordering solutions prevail in a Coasean bargain (*default* corporate contract)

VC and corporate law: a more granular view on efficient contracting

- Focus of standard L&F literature on *general* corporate law quality – as reflected in indices (!) – and properties may not capture the pivotal variable in our context

- Corporate law matters as background against which VCs and entrepreneurs structure their relationship

- Relative flexibility or rigidity of corporate law affects contract design and enforcement with efficiency implications
  - (re-)design of corporate contract causes “shapeshift” of the firm to achieve highest value structure for contracting parties
  - Corporate law impediments increase transaction costs, reduce contract value and precipitate higher cost of capital

Corporate law as determinant of shapeshifting success

- private ordering exercise causes transaction costs
- Corporate law’s properties (rigidity vs. flexibility) affect magnitude of these costs by
  - preventing the adoption of efficient solutions altogether (absolute prohibitions)
  - increasing the transaction costs, both *ex post* and *ex ante* (relative prohibitions)
- At the margin, rigid corporate law can prevent deals and VC investments

VC contracting under US (DE) and GER/ITA corporate laws

- US corporate law hospitable towards private ordering
  - Flexible → state contingent cash-flow and governance rights
  - largely standardized & presumably enforceable contracts (thanks to NVCA)
  - deferential judicial enforcement → policing opportunism
- EU corporate laws "in action" significantly less open vis-à-vis efficient shapeshifting
  - Courts, legal scholars, and practitioners (e.g., notaries) focused on *ex post* fair outcomes
  - Non-VC specific legal doctrine instrumentalized to intervene in contractual allocation of cash-flow and governance rights
  - For the full picture see Enriques, Nigro, and Tröger (2025)

Absolute prohibitions: cummulative and automatic dividends

- US VC contracts grant venture capitalists dividends payable at a liquidity event (e.g., IPO, trade sale), maturing regardless of whether the firm is profitable and independent of any deliberation by the company’s competent bodies
  - Interest-like time-value-of-money adjustment of venture capitalists’ liquidation preferences
  - Downside protection for VC
- German corporate law invariably requires dividends to be paid out of profits and mandates ad hoc shareholder involvement

Relative prohibitions: liquidation preferences

- U.S. VC contracts grant VCFs a preferred claim on the proceeds of liquidity events, e.g. the sale of the venture, encompassing the original investment and dividends
  - Allows entrepreneurs to signal their determination and trust in the venture
  - Incentivizes entrepreneurs to provide optimal effort
  - Protects VCF against downside risk and entrepreneurial opportunism
- German law prohibits any shareholder from receiving a "disproportionate" fraction of firm value → judicial review
  - Neglects mutually beneficial economic logic of VC contracts in poorly performing ventures

Policy implications

- Can we replicate US-style VC contracts in GER, ITA… (Continental) Europe? Not really!
  - Corporate law in action matters directly for VC contracting and affects both contract design and functionality
  - VC contracts are less valuable tools to structure investment relationships, which at the margin can affect investments
- How thin/thick is the margin? When the tide goes out…
- Reforms need to overcome root cause of constraints
  - Promulgation of new, laxer rules won't do!
  - Autonomous (28th) regime that limits court interventions (insulated standard VC-charter)