Venture Capital and European Corporate Laws: Bargaining in the Shadow of Regulatory Constraints

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The venture capital ("VC") industry and its managers – a.k.a. venture capitalists – have built a solid reputation for spurring innovation and economic growth, emerging as one of the crown jewels of the US economy in the 1980s and thus rather quickly turning into a dream for policymakers globally.

VC-driven value creation does largely rest on a very peculiar capital management process, which in turn requires, inter alia*, the adoption of a very complex contractual technology at the VC-backed firm level. Consistent with the predictions of financial contracting theory, this contractual technology seeks to address the multiple market imperfections inherent in the financing of high-tech firms, as well as braiding the existential logic of VC-backed firms with the VC business model's idiosyncratic organizational and operational features. Corporate law's relatively flexible or rigid design can affect the adoption of this contractual technology and its overall functionality, thus ultimately emerging, at the margin, as a determinant of contract formation and hence overall VC investment levels.*

Building on this conceptual framework, this Article compares and contrasts VC contracting under the corporate law regimes in force in the US – say, Delaware – and two major European jurisdictions – namely, Germany and Italy. In the US, taking advantage of the largely flexible design of local corporate law, venture capitalists and entrepreneurs have successfully engineered a contractual framework combining, inter alia, morphing financial claims with tailored fiduciary duties and waivers of fair value

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protections. In addition to being the closest to the predictions of financial contracting theory that transactional practice has managed to engineer, this contractual framework has proven largely resilient over both industries and investment cycles, thus emerging as a presumptively efficient solution. As such, it is, as a matter of theory, bound to be imitated globally. German and Italian corporate laws do not allow for such imitation exercise, though. The largely mandatory local corporate law regimes prevent the replication of the contractual technology governing VC deals by (i) barring the adoption of a few private ordering-based solutions, (ii) compelling contracting parties into elaborating more or less convolute workarounds to mimic the ideal solutions or (iii) rendering the adoption solutions "lame" or "unstable." This increases the costs of contracting, while striking a fatal blow to the overall functionality of the contractual technology governing VC-deals, ultimately decreasing its value.

The discussion articulated herein warrants one conclusion. To the extent that corporate law matters for attracting VC investments, German and Italian corporate laws deter, at the margin, VC investments, and generate a competitive disadvantage that can contribute the existing transatlantic gap in VC activity. Moreover, the decreased functionality of VC contracts in Germany and Italy forces venture capitalists and entrepreneurs to rely on less formal modes of governance, like, for instance social capital. We hypothesize that contracting parties replicate the US contractual framework in spite of its decreased functionality, because it serves an "expressive function": the framework corroborates social norms that are widely accepted within the VC ecosystem on both shores of the Atlantic.