

Startup Corporate Law: A Leximetrics Approach

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The development of the venture capital (VC) industry and the proliferation of so-called “unicorns”¹ raises important *legal* questions about the governance and finance of startup companies worldwide. A growing body of literature has identified and analysed some of these questions, although mainly focusing on US law. These include new agency problems,² uncertainty over duties and liability of investor-appointed directors,³ exacerbated risks for employees with stock-based compensation packages,⁴ and shadow governance structures facilitated by shareholders’ agreements.⁵ Despite increasing interest in promoting startups and VC outside the US, it is unclear whether the distinctive governance and financial arrangements observed in US VC-backed firms should be facilitated through corporate law reform and how to address the issues associated to them.⁶

To assess the pertinence and perils of promoting VC-style governance and financial structures through corporate law reform, this paper introduces the Startup Corporate Law (SCL) Index for 12 jurisdictions in Europe and Latin America.⁷ The Index provides the first comprehensive map of how corporate law rules that determine VC-backed startups’ financial and governance structures

¹ Unicorns are companies with a private valuation of one billion dollars or more. See A. Lee, *Welcome to the Unicorn Club: Learning from Billion-Dollar Startups*, TECHCRUNCH (Nov. 2, 2013), <https://techcrunch.com/2013/11/02/welcome-to-the-unicorn-club/> (last visited Feb 18 2023)

² See, e.g., E. Pollman, ‘Startup Governance’ (2019) 168 *University of Pennsylvania Law Review* 155–222; R. P. I. Bartlett, ‘Venture Capital, Agency Costs, and the False Dichotomy of the Corporation’ (2006) 54 *UCLA Law Review* 37–116.

³ M. Gelter and G. Helleringer, ‘Constituency Directors and Corporate Fiduciary Duties’ in A. S. Gold, P. B. Miller (eds.), *Philosophical Foundations of Fiduciary Law*, (Oxford: Oxford University Press, 2014), pp. 302–20; S. M. Sepe, ‘Intruders in the Boardroom: The Case of Constituency Directors’ (2013) 91 *Washington University Law Review* 309–78.

⁴ See, e.g., A. Alon-Beck, ‘Unicorn Stock Options - Golden Goose Or Trojan Horse’ (2019) 2019 *Columbia Business Law Review* 107–91.

⁵ J. E. Fisch, ‘Stealth Governance: Shareholder Agreements and Private Ordering’ (2022) 99 *Washington University Law Review* 913–60; G. Rauterberg, ‘The Separation of Voting and Control: The Role of Contract in Corporate Governance’ (2021) 38 *Yale Journal on Regulation* 1124–81.

⁶ Some attempts to address this question are C. A. Nigro and L. Enriques, ‘Venture Capital e Diritto Societario Italiano: un Rapporto Difficile’ (2021) *Analisi Giuridica dell’Economia* 149–205; L. Lin, ‘Contractual Innovation in China’s Venture Capital Market’ (2020) 21 *European Business Organization Law Review* 101–38; Z. Shishido, ‘Does Law Matter to Financial Capitalism: The Case of Japanese Entrepreneurs’ (2013) 37 *Fordham International Law Journal* 1087–1128.

⁷ In Europe, the SCL Index covers the law of France, Germany, Italy, the Netherlands, Poland, Portugal, Russia, and Switzerland; in Latin America, the law of Chile, Colombia, Mexico, and Peru.

have evolved in the twenty-first century. Following the SCL framework,⁸ the Index comprises 26 variables, each representing a corporate law rule governing startups' boards, shares, and shareholders' agreements. Variables (i.e., legal rules) were assigned a value on a given year and jurisdiction, based on the degree to which they expanded or constrained the freedom to allocate cash flow and control rights. The collection and classification of data for the Index were conducted by a multilingual team of legal researchers, using detailed Leximetrics protocols presented in APPENDIX I – CODE BOOK, which include procedures to resolve ambiguity and to code missing values. In the pursuit of clarity and accurate interpretation of the law, the team also conducted surveys with industry participants.

The SCL Index presents the first quantitative account of twenty-one years of legal evolution in SCL, providing a valuable tool for empirical researchers in venture finance and new insights on the corporate law determinants of startup finance and governance.⁹ Broadly, the Index identifies a trend towards higher flexibility or deregulation. These findings are in sharp contrast to what has been observed in dominant rankings of favorable legal environments for investment, such as shareholder protection, where there is evidence of a trend towards less flexibility.¹⁰ Such contrast corroborates that corporate law is not universally enabling and favorable for VC (at least, not yet), and that differences between listed and non-listed firms are relevant and should be accounted for by empirical studies.

Among the three areas comprising SCL (i.e., boards, shares, and shareholders' agreements), the Index reveals a general hesitance to legally empower boards, which is expressed in permanent or temporal restrictions to boards' ability to issue preferred stock or in mandatory shareholder approvals. These pervasive restrictions reduce the relevance of board representation as a control and monitoring mechanism. Representation in powerful boards is critical for venture capital investors. It enables them to actively share (or even seize) control of the portfolio startup company

⁸ See: A. Pereira, 'Designing Startup Corporate Law: A Minimum Viable Product' (2022) 41 *Review of Banking & Financial Law* 45.

⁹ In venture finance research, the dominant assessment cross-country differences in corporate law is still the anti-director index, identifying differences in the regulation of publicly traded companies and developed by La Porta, Rafael, F. Lopez-de-Silanes, A. Shleifer, and R. W. Vishny, 'Law and Finance' (1998) 106 *Journal of Political Economy* 1113–55; For example, see T. A. Khoury, M. Junkunc, and S. Mingo, 'Navigating Political Hazard Risks and Legal System Quality: Venture Capital Investments in Latin America' (2015) 41 *Journal of Management* 808–40; S. N. Kaplan, F. Martel, and P. Strömberg, 'How Do Legal Differences and Experience Affect Financial Contracts?' (2007) 16 *Journal of Financial Intermediation* 273–311; D. Cumming and S. A. Johan, 'Security Design' Venture Capital and Private Equity Contracting: An International Perspective, (Elsevier, 2014), pp. 319–68; D. Cumming, D. Schmidt, and U. Walz, 'Legality and Venture Capital Governance Around the World' (2010) 25 *Journal of Business Venturing* 54–72.

¹⁰ See H. Spamann, 'The "Antidirector Rights Index" Revisited' (2010) 23 *The Review of Financial Studies* 467–86; P. P. Lele and M. M. Siems, 'Shareholder Protection: A Leximetric Approach' (2007) 7 *Journal of Corporate Law Studies* 17–50.

to improve its performance,¹¹ and allows them to monitor entrepreneurs more effectively, supporting business development and inhibiting managerial opportunism.¹² Recent scandals involving VC-backed firms with poor governance practices are associated with a decrease in VC monitoring.¹³ To the extent that legal constraints to boards' powers make it more costly for VCs to perform a disciplining role, the findings suggest that the regulation of private firms' boards may be helpful to policymakers interested in promoting good governance in VC-backed firms.

The regulation of shares, on the contrary, has been at the heart of corporate law reforms across jurisdictions. Reforms generally enhance companies' ability to tailor the distribution of cash flow and control rights among different classes of shares. The paper discusses three specific trends in this area. First, cross-jurisdictional discrepancies on whether certain shareholders' rights can be temporarily restricted or expanded. Second, the extent to which enhanced cash flow rights assigned to certain classes of shares are treated as a contractual obligation, following the Delaware tradition,¹⁴ or otherwise. Third, the absence of reforms that explicitly enable automatic conversion of preferred to common—a key characteristic of VC investments still bounded by a high degree of uncertainty in several jurisdictions.

Regarding shareholders' agreements, the third area comprising SCL, the Index reveals a persistent legal opacity. In almost all selected jurisdictions, there is significant uncertainty on what can be governed by a shareholders' agreement and whether these agreements can be used as a substitute of the articles of association to allocate cash flow and control rights, or as a supplement, e.g., hampering the exercise of a right. The paper discusses the origins and implications of this pervasive opacity, and how different policies may contribute to promoting VC, reducing uncertainty, and increasing transparency in private markets.

Furthermore, the paper identifies and discusses the determinants of relevant trends in the evolution of SCL—e.g., legal convergence towards enabling multiple voting shares and divergence in the legal entity form reformed to promote VC across jurisdictions. The paper considers relevant

¹¹ A. Pereira, 'The Law of Contingent Control in Venture Capital' *Columbia Business Law Review* (forthcoming).

¹² R. J. Gilson, 'Engineering a Venture Capital Market: Lessons from the American Experience' (2002) 55 *Stanford Law Review* 1067–1104; P. A. Gompers, 'Optimal Investment, Monitoring, and the Staging of Venture Capital' (1995) 50 *The Journal of Finance* 1461–89.

¹³ To be sure, the decline in VC monitoring is generally attributed to changes in the market and in investment styles. Still, legal constraints likely foster this trend further or, worse, induce VCs to include harsher, trust-constraining terms when funding companies with weaker bargaining powers. For a general account on recent changes in investment styles, see S Mallaby, *The Power Law: Venture Capital and the Art of Disruption* (Allen Lane, 2022). For a case study on how legal constraints may lead to trust-constraining agreements see L. Lin, 'Contractual Innovation in China's Venture Capital Market' (2020) 21 *European Business Organization Law Review* 101–38

¹⁴ See, generally, W. W. Bratton and M. L. Wachter, 'A Theory of Preferred Stock' (2013) 161 *University of Pennsylvania Law Review* 1815–1906.

differences between the evolution of SCL in Europe and Latin America, and the extent to which economic integration has influenced legal reforms in these regions.

Finally, the paper considers the potential impact of observed changes in SCL on VC from two perspectives. On the one hand, how such changes may contribute to the development of VC and the rise of unicorns across the sampled jurisdictions by facilitating VC-style governance and financial structures. On the other hand, how differences in corporate law doctrines across jurisdictions may assist or make it more challenging to address emerging issues associated with VC-style agreements—i.e., new agency problems, duties of constituency directors, risks derived from stock-based compensation packages, and shadow governance structures relying on shareholders' agreements.

Overall, the paper makes two specific contributions. First, it introduces the SCL Index, the first quantitative account of the evolution of corporate law rules critical to developing VC markets and the rise of unicorns. This dataset aims to significantly improve the accuracy of empirical studies in venture finance, which currently must rely on second-best and often inaccurate representations of corporate law across jurisdictions and time series (e.g., anti-director index, which captures the regulation of listed companies). Second, it evaluates the determinants and potential impact of concrete reforms and relevant trends in SCL, offering new insights to assess the benefits and costs of promoting VC-style governance and financial structures through corporate law reform.