

LAW AND DEVELOPMENT OF THE VENTURE CAPITAL MARKET

DIREITO E DESENVOLVIMENTO DO MERCADO DE VENTURE CAPITAL

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Abstract

The venture capital industry plays an important role in financing of startups. Several countries have adopted measures to promote the activities of innovative companies, as well as venture capital (VC) investments. Scholars examine various economic and institutional factors that determine VC investment levels across countries. The objective of this article is to analyze how law can influence the development of the venture capital market. To this end, it presents a literature review on the legal aspects considered essential for the growth of VC markets in various countries, focusing on corporate law aspects. The article identifies that law may impact the VC market through three central elements: (i) the availability of capital in this sector; (ii) the existence of appropriate legal institutions to enable the activities of financial intermediaries; and (iii) the existence of a favorable environment for the development of innovative businesses by entrepreneurs.

Keywords. Venture Capital, Corporate Law, Startups, Corporate Governance, Corporate Finance, Contract Law.

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Resumo

O mercado de venture capital desempenha um papel importante no financiamento de startups. Diversos países vêm adotando medidas para promover as atividades de startups, bem como investimentos em venture capital (VC). A literatura analisa diversos fatores econômicos e institucionais que determinam os níveis de investimento em VC entre diferentes países. O objetivo deste artigo é analisar como o direito pode influenciar o desenvolvimento do mercado de VC. Para isso, apresenta uma revisão da literatura sobre os aspectos jurídicos considerados essenciais para o crescimento dos mercados de VC em diversos países, com foco nos aspectos de direito societário. A partir da revisão de literatura, o artigo identifica como o direito pode impactar o mercado de VC por meio de três elementos centrais: (i) a disponibilidade de capital neste setor; (ii) a existência de instituições jurídicas adequadas para viabilizar as atividades dos intermediários financeiros; e (iii) a existência de um ambiente favorável para o desenvolvimento de negócios inovadores por empreendedores.

Palavras-chave. Venture Capital, Direito Societário, Startups, Governança Corporativa, Finanças Corporativas, Direito Contratual.

1. Introduction. 2. The Existence of Capital: Availability of Financial Resources. A. State Incentives; B. Regulatory Aspects: Participation of Institutional and Foreign Investors; C. Tax Incentives; **3. The Role of Financial Intermediaries: Venture Capital Funds.** A. Limited Partnerships; B. Exit Conditions and Disinvestment; **4. The Role of Entrepreneurs: Founders and Startups.** A. The Role of Corporate Law; B. Civil Insolvency Regime; C. Labor Law Aspects. **5. Conclusion. 6. References.**

1. INTRODUCTION²³⁹

The Brazilian venture capital (VC) market has experienced significant growth in recent years. In 2023, 770 venture capital financing transactions were executed in Latin America, amounting to approximately \$3.7 billion invested²⁴⁰. This is a substantial increase compared to 2016, when only \$0.5 billion was invested across 197 deals²⁴¹. Brazil plays a key role in these figures, accounting for 42% of the deals and 44% of the capital invested in Latin America's VC market in 2023²⁴². Despite the considerable growth witnessed in recent years, the venture capital market in Brazil still lags far behind the figures of the United States of America (U.S.) and Europe's venture capital industries. In 2022, over 13,380 companies in the U.S. received \$205 billion in VC investments²⁴³. On the other hand, Europe recorded 8,880 VC financing transactions, amounting to \$88.5 billion²⁴⁴.

Several countries have adopted measures to promote the activities of innovative companies, as well as venture capital investments²⁴⁵.

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240 According to data from the report on Latin America 2024 Industry Data & Analysis from the Association for Private Capital Investment in Latin America (LAVCA). Available at: <https://www.lavca.org/research/2024-lavca-industry-data-analysis/>

241 According to data from the report on Latin America 2024 Industry Data & Analysis from the Association for Private Capital Investment in Latin America (LAVCA). Available at: <https://www.lavca.org/research/2024-lavca-industry-data-analysis/>

242 According to data from the report on Latin America 2024 Industry Data & Analysis from the Association for Private Capital Investment in Latin America (LAVCA). Available at: <https://www.lavca.org/research/2024-lavca-industry-data-analysis/>

243 According to data from CB INSIGHTS, *State of Venture - Global 2022*. Available at https://static1.squarespace.com/static/56cbee6301dbae33a826e622/t/6426fcde4e6cbc5da369b923/1680276707142/CB-Insights_State-of-Venture-Report-2022.pdf

244 According to data from CB INSIGHTS, *State of Venture - Global 2022*. Available at https://static1.squarespace.com/static/56cbee6301dbae33a826e622/t/6426fcde4e6cbc5da369b923/1680276707142/CB-Insights_State-of-Venture-Report-2022.pdf

245 LIN, Lin. *Venture capital law in China*. Cambridge: Cambridge University Press, 2021, p. 1. ARMOUR, John. Personal insolvency law and the demand for venture

Scholars examine various economic and institutional factors that determine VC investment levels across countries²⁴⁶. Numerous studies explore the potential relationships between law and venture capital investment levels in certain countries²⁴⁷. Among these, a seminal work in the field is Ronald Gilson's article entitled "Engineering a Venture Capital Market: Lessons from the American Experience." In this article, the author analyzes the U.S. VC market and identifies three factors that have contributed to its development. Briefly, these three factors are: (i) the availability of financial resources dedicated to the VC sector; (ii) the role of financial intermediaries; and (iii) the presence of entrepreneurs²⁴⁸. Building on Gilson's classification, this article systematizes the literature by identifying the ways in which law can influence the development of the venture capital market²⁴⁹.

capital. *European business organization law review*, v. 5, p. 87-118, 2004, p. 88.

246 JENG, Leslie A.; WELLS, Philippe C. The determinants of venture capital funding: evidence across countries, *Journal of Corporate Finance*, v. 6, p. 241-289, 2000. LERNER, J; TÅG, J. Institutions and Venture Capital. IFN Working Paper No. 897, 2012. Available at SSRN: <https://ssrn.com/abstract=1979249>. BONINI, S; ALKAN, S. The political and legal determinants of venture capital investments around the world. *Small Business Economics*, v. 39, n. 4, pp. 997-1016, 2012. LERNER, J. The future of public efforts to boost entrepreneurship and venture capital. *Small Business Economics*, v. 35, n. 3, 255-264, 2010.

247 See ARMOUR, John. Personal Insolvency Law and the Demand for Venture Capital. *European Business Organization Law Review*, v. 5, p. 87-118, 2004, p. 88. BLACK, B.S.; GILSON, R.J. Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, *Journal of Financial Economics*, v. 47, 1998; e JENG, Leslie A.; WELLS, Philippe C. The Determinants of Venture Capital Funding: Evidence Across Countries, *Journal of Corporate Finance*, v. 6, p. 241-289, 2000.

248 GILSON, R.J. Engineering a Venture Capital Market: Lessons from the American Experience. *Stanford Law Review*, v. 55, n. 4, p. 1067-1103, 2003, p. 1069, 1093.

249 Other alternative classifications of the ways in which law can influence venture capital investments are: (i) according to factors affecting supply (i.e., the interest of investors in allocating financial resources to this market) vs. factors affecting demand (i.e., the interest of entrepreneurs in developing projects and new ventures), a classification adopted by John Armour (ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003); and (ii) according to the different stages of a VC investment cycle, namely: fundraising, investment, and exit, as adopted by Lin Lin in LIN, Lin. *Venture Capital Law in China*. Cambridge: Cambridge University Press, 2021. Lin Lin, in the article entitled "Engineering a Venture Capital Market: Lessons from China," also draws on Gilson's classification to analyze the development of the venture capital market, focusing

The first one is the availability of capital for investment, which, in the context of the venture capital market, is characterized by being a specific type of capital aimed at early-stage companies, with a high potential for financial returns as well as high risk²⁵⁰. The second factor consists of the existence of specialized financial intermediaries, who operate in this market by investing in selected companies, thus serving as intermediaries between final investors and companies. The existence of entrepreneurs is the third factor mentioned by Gilson as necessary for the creation of a venture capital market. According to the author, the existence of entrepreneurs depends on the availability of capital and specialized financial intermediaries²⁵¹.

Considering these three factors, the question the article seeks to explore is how law can influence the development of the venture capital market. To this end, it presents a literature review of the legal aspects considered essential for the growth of VC markets across various countries, focusing on corporate law aspects. The texts included in the literature review were selected based on an initial and broad search using the keywords “venture capital,” “law,” and “development.” This search was conducted in the databases SSRN, JSTOR, Google Scholar, and Revista dos Tribunais. In each database, articles, books and book chapters addressing legal aspects and their influence on the development of the venture capital market were selected. The selection comprised works analyzing the influence of various legal factors from a comparative perspective, as well as studies investigating the impact of specific rules and legal institutions on VC investments in different jurisdictions. The reviewed texts utilized both quantitative and qualitative methodologies. The primary criterion for selection was relevance to the topic. Additionally, the review incorporated texts not

exclusively on China. See LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017.

250 GILSON, R.J. Engineering a Venture Capital Market: Lessons from the American Experience. *Stanford Law Review*, v. 55, n. 4, p. 1067-1103, 2003, p. 1070-1072.

251 GILSON, R.J. Engineering a Venture Capital Market: Lessons from the American Experience. *Stanford Law Review*, v. 55, n. 4, p. 1067-1103, 2003, p. 1102-03.

identified in the initial search but cited in previously selected works and deemed pertinent to the article's subject.

The article is divided into three main sections, in addition to this introduction and the conclusion. Section 1 examines the legal factors influencing capital availability, analyzing how law may affect access to capital. Section 2 discusses how legal aspects can impact the activity of financial intermediaries in the VC market. Finally, Section 3 addresses the legal factors that can influence the presence of entrepreneurs and the development of a favorable entrepreneurial environment for VC investments.

2. THE EXISTENCE OF CAPITAL: AVAILABILITY OF FINANCIAL RESOURCES

For VC activities to take place, it is necessary that there are investors willing to allocate financial resources to this market. There are two main categories of financial resources dedicated for venture capital investments: public and private resources²⁵². Generally, the capital committed to the VC industry comes from the following classes of investors: pension funds, private companies, banks, insurers, government, and public companies²⁵³. This section examines the legal aspects that can influence the level of capital available for VC investments, focusing on the role of government incentive programs, the regulation applicable to the activities of institutional and foreign investors, as well as tax incentives within this context.

A. STATE INCENTIVES

One approach to increasing the levels of committed capital in the VC industry is through government programs aimed at promoting

252 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 171.

253 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 171.

investments in this sector. Lin Lin, in discussing the development of the venture capital market in China, highlights the central role of state incentives in that country's market²⁵⁴. The author shows how, in China, a substantial portion of VC investments has been made through government-established investment funds, called "Government Guidance Funds - GGFs" (*zhengfu yiandao jijin*)²⁵⁵. This program was created to increase the volume of resources available for investments in early-stage companies, particularly technology-based ones²⁵⁶. Recent examples from other countries that have created investment funds with public resources for startup investments include New Zealand²⁵⁷, Singapore²⁵⁸, and Brazil²⁵⁹.

In Brazil, the first initiatives of this kind date back to the 1970s²⁶⁰. In 1974, the Brazilian government defined its initial efforts to encourage equity financing for small and medium-sized enterprises. In 2001, the government launched the Inovar Program, aimed at

254 Other countries with government programs aimed at investing in startups include New Zealand — through the creation of the 'New Zealand Venture Investment Fund' — and Singapore, through the establishment of the 'Singapore Early-Stage Venture Fund. See LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 171.

255 LIN, Lin. *Venture Capital Law in China*. Cambridge: Cambridge University Press, 2021, p. 92-98.

256 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 171. Regarding issues identified in the practice of this type of fund, the GGFs, see LIN, Lin. *Venture Capital Law in China*. Cambridge: Cambridge University Press, 2021, p.98-104.

257 LERNER, Josh et al. *A Study of New Zealand Venture Capital and Private Equity Market and Implications for Public Policy*, LECG, 2005. Available at: <https://thehub.swa.govt.nz/assets/documents/MoRST%20Venture%20Capital%20Market%20Study%202005.pdf>

258 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p.171.

259 See <https://www.bndes.gov.br/wps/portal/site/home/mercado-de-capitais/fundos-de-investimentos/fip-anjo-startups>. Also see MAZZUCATO, Mariana; PENNA, Caetano. The Brazilian Innovation System: A Mission-Oriented Policy Proposal. Centro De Gestão E Estudos Estratégicos, 2016, p.57-59. Available at: <https://www.cgee.org.br/the-brazilian-innovation-system>.

260 LIMA JÚNIOR, Irineu de Souza et al. An Institutional Perspective on the Development of the Venture Capital Market in Brazil. In: *Entrepreneurial Finance, Innovation and Development*. 1st edition [Online]. Routledge. pp. 120–145, 2022.

creating a venture ecosystem in Brazil ²⁶¹. The Brazilian Development Bank (BNDES) also established several key investment funds focused on emerging and innovative companies, such as Criatec (in 2007, 2013, and 2016) and FIP Anjo, created in 2018²⁶².

State incentives in this regard are important not only for increasing the amount of capital available for investments in early-stage companies but also for encouraging other investors to allocate their financial resources to this type of investment ²⁶³. However, there is controversy in the literature about the impact of state incentives on the development of VC markets. A study by Armour and Cumming suggests that the implementation of state subsidy programs would not help promote the VC market; on the contrary, it could potentially discourage private investment in the sector ²⁶⁴.

B. REGULATORY ASPECTS: PARTICIPATION OF INSTITUTIONAL AND FOREIGN INVESTORS

Considering the transnational nature of the VC market, a favorable regulatory environment is essential to attract foreign

261 LEAMON, A.; LERNER, J. *Creating a Venture Ecosystem in Brazil: FINEP's INOVAR Project*. Boston, MA: Harvard Business School, 2012. For a summary on the history of VC in Brazil, see LIMA JÚNIOR, Irineu de Souza et al. An Institutional Perspective on the Development of the Venture Capital Market in Brazil. In: *Entrepreneurial Finance, Innovation and Development*. 1st edition [Online]. Routledge. pp. 120-145, 2022

262 LIMA JÚNIOR, Irineu de Souza et al. An Institutional Perspective on the Development of the Venture Capital Market in Brazil. In: *Entrepreneurial Finance, Innovation and Development*. 1st edition [Online]. Routledge. pp. 120-145, 2022, p. 125-126.

263 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p.171.

264 Ver ARMOUR, John; CUMMING, Douglas. The Legislative Road to Silicon Valley. *Oxford Economic Papers*, v. 58, n. 4, p. 596-635, 2006, p. 630-631. For other studies questioning whether public subsidies have positive or negative effects, see LELUX, Benoit; SURLEMONT, Bernard. Public versus Private Venture Capital: Seeding Or Crowding Out? A Pan-European analysis, *Journal of Business Venturing*, v. 18, n. 1, p-81-104, 2003; and CUMMING, Douglas. Government Policy Towards Entrepreneurial Finance Innovation Investment Funds, *Journal of Business Venturing*, v.22, n. 2, p.196-235, 2007.

investors²⁶⁵. China's experience demonstrates how state regulation can influence the levels of venture capital within country. The presence of institutional investors, such as investment banks, insurers, and pension funds in the Chinese VC market grew significantly after 2008, following the implementation of regulatory reforms. As Lin Lin demonstrates, since 2008, institutions like the China Securities Regulatory Commission, along with insurance and banking sector regulators have allowed institutional investors to participate in equity investments²⁶⁶.

The availability of resources for VC investments is also influenced by regulations affecting foreign investors. China's experience also illustrates this relationship, with regulatory reforms, especially since 1995, focused on encouraging the formation of foreign investment funds dedicated to the VC sector²⁶⁷. In this regard, Lin Lin highlights the creation of the "Regulations on the Administration of Foreign Invested Venture Capital Enterprises," allowing foreigners to invest in the Chinese market through the creation of a new investment vehicle - "Foreign Invested Venture Capital Enterprise - FIVCIE."²⁶⁸

Brazil has recently experienced a rise of foreign investors participating in VC investment rounds²⁶⁹. According to data from KPMG, foreign investors have increased their participation in the Brazilian private equity and venture capital industry from 54% in 2011 to 71% in 2019²⁷⁰. In recent years, both the number of companies

265 LERNER, J. The Future of Public Efforts to Boost Entrepreneurship and Venture Capital. *Small Business Economics*, v. 35, n. 3, p. 255-264, 2010.

266 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p.171.

267 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 177.

268 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 177.

269 LIMA JÚNIOR, Irineu de Souza et al. An Institutional Perspective on the Development of the Venture Capital Market in Brazil. In: *Entrepreneurial Finance, Innovation and Development*. 1st edition [Online]. Routledge. pp. 120-145, 2022, p 131.

270 KPMG; ASSOCIAÇÃO BRASILEIRA DE PRIVATE EQUITY E VENTURE CAPITAL. *Data Consolidation: Private Equity and Venture Capital Industry in Brazil 2015 - 2016 - 2017 - 2018 - 2019 - 2020*, 2020.

receiving investments and the total amount of venture capital funding have grown significantly²⁷¹.

C. TAX INCENTIVES

The tax framework is another factor highlighted in the literature as crucial for increasing the availability of private capital in venture capital markets²⁷². By analyzing data from the venture capital and private equity industries of Austria, Belgium, Canada, Norway, Finland, France, Germany, Ireland, Italy, the Netherlands, Portugal, Spain, Sweden, the United Kingdom, and the United States from 1990 to 2003, Armour and Cumming demonstrate how an appropriate tax regime, with adjusted incentives, can support the creation of VC and PE funds, thereby increasing the availability of financial resources for investments in these markets²⁷³.

Tax reforms implemented by China also illustrate this relationship, with fiscal reforms aimed at encouraging the formation and structuring of financial intermediaries in the form of VC investment funds, including management institutions (general partners – GPs) and investors (limited partners – LPs)²⁷⁴. According to data gathered by Lin Lin, the majority of investors in the Chinese VC market today are

271 KPMG; ASSOCIAÇÃO BRASILEIRA DE PRIVATE EQUITY E VENTURE CAPITAL. *Data Consolidation: Private Equity and Venture Capital Industry in Brazil 2015 – 2016 – 2017 – 2018 – 2019 – 2020*, 2020.

272 ARMOUR, John; CUMMING, Douglas. The Legislative Road to Silicon Valley. *Oxford Economic Papers*, v. 58, n. 4, p. 596-635, 2006; LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 178. There are also studies that demonstrate how different tax rules can lead to different ways of structuring VC investments. In this regard, see, GILSON, R.J.; SCHIZER, D.M. Understanding Venture Capital Structure: a Tax Explanation for Convertible Preferred Stock, *Harvard Law Review*, v. 116, p. 874-916, 2003; LERNER, Josh; SCHOAR, Antoinette. Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity, *The Quarterly Journal of Economics*, p. 223-246, 2005.

273 ARMOUR, John; CUMMING, Douglas. The Legislative Road to Silicon Valley. *Oxford Economic Papers*, v. 58, n. 4, p. 596-635, 2006, p. 613-628.

274 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 178-179.

individuals and families (53%), followed by private companies (14.6%) and investment banks (9.4%)²⁷⁵. There is also a growing number of VC funds being created by private sector companies, such as Tencent and Alibaba. Interviews conducted by Lin Lin indicate that the tax incentives adopted in China have contributed to investors' interest in the VC market, thereby increasing the levels of committed capital within the Chinese VC industry ²⁷⁶.

3. THE ROLE OF FINANCIAL INTERMEDIARIES: VENTURE CAPITAL FUNDS

Venture capital investment funds serve as financial intermediaries by raising capital from end-investors and applying these funds to finance the activities of startups²⁷⁷. In this context, the legal framework plays an important role by enabling (or hindering) the existence of investment vehicles capable of allocating rights and obligations in such a way that they are attractive for investments in the VC market.

A. LIMITED PARTNERSHIPS

Regarding financial intermediaries, one of the primary ways in which the law influences venture capital investment levels is through the legal forms and structures available in a given country for organizing financial resources under VC management ²⁷⁸. Since the

275 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 178-179.

276 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 179.

277 ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 134.

278 ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 148.

1970s, the predominant vehicle for structuring investments in the U.S. VC market has been the limited partnership²⁷⁹.

Thus, it is important to broadly analyze how financial intermediaries in the U.S. VC market are traditionally organized under the limited partnership structure, which may help understand the relevance of this legal form for the development of the VC market. A limited partnership comprises two types of partners: investors (limited partners – LP), whose role is to provide capital to form the partnership, having limited liability and no right to participate in management, and managers (general partners – GP), who allocate these resources by investing in companies, thus having some management rights in the invested companies²⁸⁰. Contractually, the limited partnership is governed by a partnership agreement, which provides the necessary flexibility for its partners to align their interests²⁸¹. Investors typically have voting rights over certain changes to the partnership agreement, such as its liquidation, extension of the fund's duration, and removal of a general partner²⁸². The limited partnership holds both the financial resources for future investments and the shares of the startups that are part of the partnership's portfolio.

According to research by Lin Lin, in recent years, several countries, such as Singapore, New Zealand, Taiwan, Japan, and Switzerland, have implemented reforms in their legal systems to introduce the limited partnership structure to attract more equity

279 GOMPERS, Paul; LERNER, Josh. *The Venture Capital Cycle*. 2nd ed. Cambridge, Mass: MIT Press, 2004, p 9-10.

280 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 181.

281 For a review about the legal and organizational structure of partnerships, see MCCAHERY, Joseph; RENNEBOOG, Luc. Venture Capital Financing of Innovative Firms: an Introduction. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p.5-7; LIN, Lin. Engineering a venture capital market: lessons from China...p. 182.

282 MCCAHERY, Joseph; RENNEBOOG, Luc. Venture capital financing of innovative firms: an introduction...p.5.

investments²⁸³. Similarly, other countries that already had limited partnerships in their systems, such as the United Kingdom and Australia, have implemented reforms to encourage investment growth in this sector²⁸⁴. In 2006, China introduced the limited partnership in its system through reforms in its Partnership Enterprise Law, which was part of the Chinese government's initiative to promote scientific innovation, recognizing venture capital investment promotion as a key element for innovation and sustainable economic development²⁸⁵.

B. EXIT CONDITIONS AND DISINVESTMENT

In the context of the VC investment, the exit event is crucial²⁸⁶. Generally, the main exit strategies are: (i) an initial public offering (IPO); (ii) a trade sale to a third-party strategic buyer, implemented through mergers or acquisitions of the invested company by another company in the same economic sector; (iii) a secondary sale to another investor; (iv) a buyback, implemented by the entrepreneur repurchasing the

283 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p.181. ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p.148. For a description of the organizational forms of VC funds in China from a comparative perspective, see LIN, Lin. *Venture Capital Law in China*. Cambridge: Cambridge University Press, 2021, p. 45-92.

284 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 181. MCCAHERY, Joseph; VERMEULEN, Erik. Limited Partnership Reform In The United Kingdom: A Competitive, Venture Capital Oriented Business Form, *European Business Organization Law Review*, v. 5, p. 61- 85, 2004, p. 72.

285 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, 182-184.

286 See BLACK, B.S.; GILSON, R.J. Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, *Journal of Financial Economics*, v. 47, p.243-277, 1998, p. 252-257, for a theory on the importance of exit strategies for VCs, both from the perspective of their relationship with the fund's investors and with regard to the portfolio companies.

investor's equity stake; and (v) a write down, achieved through the dissolution and liquidation of the invested company²⁸⁷.

In this regard, a capital market that facilitates IPOs for smaller companies is another factor that significantly impacts the VC market. The literature suggests a correlation between the size and liquidity of a country's capital market and the size of its VC market²⁸⁸. According to a study by Black and Gilson, when comparing countries whose economies are more capital market-centered with those where the banking system is stronger, the VC market is more developed in the former group²⁸⁹. The authors argue that the possibility of exit through an IPO is essential for the development of an active VC market because this type of exit allows investors and entrepreneurs to enter into a kind of implicit contract regarding control of the invested company, which would not be replicable in a bank-centered system²⁹⁰.

287 CUMMING, Douglas; MACINTOSH, Jeffrey. A cross-country comparison of full and partial venture capital exits, *Journal of Banking and Finance*, v. 27, n. 3, p. 511-548, 2003, p. 511-512.

288 See BLACK, B.S.; GILSON, R.J. Does Venture Capital Require an Active Stock Market? *Journal of Applied Corporate Finance*, v. 11, n. 4, 1999; ROCK, Edward. Greenhorns, Yankees, and Cosmopolitans: Venture Capital, IPOs, Foreign Firms, and U.S. Markets, *Theoretical Inquiries in Law*, v.2, p.711-744, 2001; MAYER, Colin et al. Sources of funds and investment activities of venture capital funds: evidence from Germany, Israel, Japan and the United Kingdom, *Journal of Corporate Finance*, v. 11, n. 3, p.586-608, 2005; e JENG, Leslie A.; WELLS, Philippe C. The Determinants of Venture Capital Funding: Evidence Across Countries, *Journal of Corporate Finance*, v. 6, p. 241-289, 2000.

289 BLACK, B.S.; GILSON, R.J. Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, *Journal of Financial Economics*, v. 47, 1998. The authors present data from the markets of different countries supporting the correlation between the development of the capital markets and the venture capital market. This correlation can be observed in the markets of Japan and Germany, whose systems are centered around the banking sector and feature smaller venture capital markets compared to those in the United Kingdom and the United States, which are centered around the capital markets. Furthermore, the authors also provide data on how the development of the venture capital market in Israel was marked by the implementation of exits for investors through initial public offerings on NASDAQ, thus using institutions available in the North American market. BLACK, B.S.; GILSON, R.J. Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, *Journal of Financial Economics*, v. 47, 1998.

290 For a complete description of the theory developed by the authors, see BLACK, B.S.; GILSON, R.J. Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets, *Journal of Financial Economics*, v. 47, 1998, p. 258-264.

This correlation can be evidenced by China's experience, as noted by Lin Lin²⁹¹. The Chinese experience shows how legal system reforms aimed at improving the institutional structure and regulatory environment of the capital market can encourage exits through IPOs and, consequently, the development of the capital market. The author demonstrates how the creation of three stock exchanges in China since 1990 has offered and encouraged VC fund disinvestment operations through IPOs²⁹². In 2009, the ChiNext stock exchange was created, inspired by the NASDAQ model, with more flexible listing requirements compared to the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE)²⁹³. In 2016, 148 companies that received VC and PE investments went public and were listed on the Chinese capital market, accounting for 61.5% of the total disinvestment operations carried out by investors that year²⁹⁴.

4. THE ROLE OF ENTREPRENEURS: FOUNDERS AND STARTUPS

The third factor identified by Gilson as necessary for the formation of a venture capital market is the existence of entrepreneurs. Several factors highlighted by the literature can be grouped around

291 For a description and empirical data on the correlation between the capital markets and the venture capital market, based on the experience of China see LIN, Lin. Venture Capital Exits and the Structure of Stock Market in China. *Asian Journal of Comparative Law*, v. 12, n. 1, p.1-40, 2017.

292 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 179-180; LIN, Lin. Venture Capital Exits and the Structure of Stock Market in China. *Asian Journal of Comparative Law*, v. 12, n. 1, p.1-40, 2017, p. 6-10.

293 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 179-180.

294 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 179-180. Despite the successes of some reforms, several institutional aspects persist in the Chinese market that hinder the existence of a more efficient capital market. For a summary of these aspects, see LIN, Lin. Venture Capital Exits and the Structure of Stock Market in China. *Asian Journal of Comparative Law*, v. 12, n. 1, p.1-40, 2017, p.18-23.

this category, which are considered determinants for the development of the venture capital industry.

A. THE ROLE OF CORPORATE LAW

The legal frameworks available in a given country concerning the legal entities through which entrepreneurs can structure their activities under a separate legal entity are another way in which law can be significant for the VC market in a given country. Few studies have explored the relationship between corporate law and the development of the VC market²⁹⁵.

Initially, the literature examined the correlation between the levels of investor protection and VC investments. While some studies found no correlation²⁹⁶, others identified a negative correlation between one and the other²⁹⁷. Allen and Song analyzed whether the level and growth of VC investments in different countries are influenced by corporate governance²⁹⁸. The authors, based on the paper of La

295 For studies recognizing this gap see NIGRO, Casimiro; ENRIQUES, Luca. Venture Capital e Diritto Societario Italiano: Un Rapporto Difficile [Venture Capital and Italian Corporate Law: A Complex Relationship], *Analisi Giuridica dell'Economia*, v. 1., 2021, p. 155; PEREIRA, Alvaro. The Law of Contingent Control in Venture Capital, *Colum. Bus. L.Rev.*, v. 2023, n. 2, p. 675, 2023, p. PEREIRA, Alvaro. Designing Startup Corporate Law: A Minimum Viable Product, *Rev. Banking & Fin. L.*, v. 42, p. 367, 2022, p. 373. GIUDICI, P., AGSTNER, P.; CAPIZZI, A. The Corporate Design of Investments in Startups: A European Experience. *Eur Bus Org Law Ver*, v. 23, p. 787-820, 2022.

296 JENG, Leslie A.; WELLS, Philippe C. The Determinants of Venture Capital Funding: Evidence Across Countries, *Journal of Corporate Finance*, v. 6, p. 241-289, 2000. "By regressing venture capital investments on shareholder rights and legal origin dummies in Table 9B, we can show to what extent these investments are dependent on the variables underlying IPOs. Rule of Law and Anti-director Rights are not significant in this regression" P. 270.

297 ALLEN, Franklin; SONG, Wei-ling. Venture Capital and Corporate Governance. In: CORNELIUS P.K. e KOGUT B., *Corporate Governance and Capital Flows in a Global Economy*. Oxford: Oxford University Press, 2003, pp. 133 ss.

298 ALLEN, Franklin; SONG, Wei-ling. Venture Capital and Corporate Governance. In: CORNELIUS P.K. e KOGUT B., *Corporate Governance and Capital Flows in a Global Economy*. Oxford: Oxford University Press, 2003, p. 148.

Porta et al.²⁹⁹, used measures of investor protection and contract enforcement as proxies for corporate governance effectiveness and examined their impact on VC activity across various countries. Allen and Song's findings indicate that venture capitalists seek to invest in countries with better creditor protection rather than shareholder protection, which would be more relevant for publicly traded firms³⁰⁰.

Subsequent research has analyzed the role of enforcement in the development of the venture capital markets. A study by Lerner and Schoar indicates that countries with a common law tradition and a stronger legal enforcement are associated with more developed VC markets. The findings of Lerner and Schoar research suggest that systematic differences in legal enforcement may limit the type of contracts that parties can enter into³⁰¹. The authors analyzed 210 transactions from thirty distinct countries that occurred between 1987 and 2003. They found that transactions in common law jurisdictions and with better contract enforcement are far less likely to use common shares, and more likely to use convertible preferred stock³⁰². On the other hand, in countries with civil law background and where legal enforcement is difficult, the investments relied on majority control, used debt more often and also have more board representation. Lerner and Schoar argue that ownership could be a substitute for the lack of contractual protection³⁰³. Although, the authors discuss that

299 ALLEN, Franklin; SONG, Wei-ling. Venture Capital and Corporate Governance. In: CORNELIUS P.K. e KOGUT B., *Corporate Governance and Capital Flows in a Global Economy*. Oxford: Oxford University Press, 2003, p. 153.

300 ALLEN, Franklin; SONG, Wei-ling. Venture Capital and Corporate Governance. In: CORNELIUS P.K. e KOGUT B., *Corporate Governance and Capital Flows in a Global Economy*. Oxford: Oxford University Press, 2003, p. 153.

301 LERNER, Josh; SCHOAR, Antoinette. Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity, *The Quarterly Journal of Economics*, p. 223-246, 2005, p. 224-225.

302 LERNER, Josh; SCHOAR, Antoinette. Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity, *The Quarterly Journal of Economics*, p. 223-246, 2005, p. 224-225.

303 LERNER, Josh; SCHOAR, Antoinette. Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity, *The Quarterly Journal of Economics*, p. 223-246, 2005, p. 224-225.

this substitution could lead to less developed VC markets. The reason for that is that investors would have difficulties in diversifying their portfolio, given that they would need to rely on larger equity stakes³⁰⁴. The entrepreneur, on the other side, would be forced to give up a substantial amount of cash flow and control rights early on³⁰⁵.

Recent scholarship has observed that there is more to the relationship between corporate law and VC investment levels, showing that the level of flexibility of the corporate law of a given jurisdiction also matters. According to these studies, a flexible corporate law is necessary for the development of a VC market, so that venture capitalists and entrepreneurs can tailor investments according to the particularities of the VC business model³⁰⁶. In other words, the corporate law of a given jurisdiction could also be relevant due to its greater or lesser suitability to allow VC, and entrepreneurs allocate decision-making powers and cash-flow rights in a way suitable for the needs of companies based on a highly innovative entrepreneurial project³⁰⁷.

304 LERNER, Josh; SCHOAR, Antoinette. Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity, *The Quarterly Journal of Economics*, p. 223-246, 2005, p. 224-225.

305 LERNER, Josh; SCHOAR, Antoinette. Does Legal Enforcement Affect Financial Transactions? The Contractual Channel in Private Equity, *The Quarterly Journal of Economics*, p. 223-246, 2005, p. 224-225.

306 See NIGRO, Casimiro; ENRIQUES, Luca. Venture Capital e Diritto Societario Italiano: Un Rapporto Difficile [Venture Capital and Italian Corporate Law: A Complex Relationship], *Analisi Giuridica dell'Economia*, v. 1., 2021; NIGRO, Casimiro; GÖZLÜGÖL, Alperen A. Building an EU Venture Capital Market: What About Corporate Law? In: GIMIGLIANO, G.; CATTELAN, V. (eds.) *Money Law, Capital, and the Changing Identity of the European Union*. Oxford: Hart Publishing, 2022, p.169; ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 135; GIUDICI, Paolo; AGSTNER, Peter. Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?), *Eur Bus Org Law Rev*, v. 20, p. 597-632, 2019; MCCAHERY, Joseph; VERMEULEN, Erik. Business Organization Law and Venture Capital. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 162-187.

307 NIGRO, Casimiro; ENRIQUES, Luca. Venture Capital e Diritto Societario Italiano: Un Rapporto Difficile [Venture Capital and Italian Corporate Law: A Complex Relationship], *Analisi Giuridica dell'Economia*, v. 1., 2021, p. 155.

One of the aspects highlighted in the literature regarding the implications of flexible corporate law rules is the ability of the parties involved in an investment transaction to modify and define specific governance rules provided in the company's charter or articles of association³⁰⁸. Venture capitalists and entrepreneurs enter into a myriad of complex contracts designed to achieve two major objectives³⁰⁹. First, they were designed to mitigate uncertainty, informational asymmetries, and moral hazard risks by enhancing parties' incentives to promptly disclose all relevant information and expend optimal efforts to maximize overall enterprise value³¹⁰. Second, the VC contracts were also designed to align with the biphasic structure of VC investments, i.e. one phase aimed at generating value and other at its monetization, which would give the VC the right to, at a certain point in the startup life cycle, divest and generate liquidity to the final investors³¹¹. Furthermore, these contracts include numerous clauses designed to ensure its self-enforcement³¹². Specifically,

308 ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p.149. MCCAHERY, Joseph; VERMEULEN, Erik. Business organization law and venture capital. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 172.

309 NIGRO, Casimiro; ENRIQUES, Luca. *Venture Capital e Diritto Societario Italiano: Un Rapporto Difficile...*p. 156.

310 See STROMBERG, Per; KAPLAN, Steven. Financial Contracting Theory Meets the Real World: an Empirical Analysis of Venture Capital Contacts, *The Review of Economic Studies*, v. 70, n. 2, p. 281-315, 2003. For an analyzes on stage financing and the use of convertible securities in VC financing, from an economic perspective see CORNELLI F. e YOSHA O. Stage Financing and the Role of Convertible Securities, v. 70, n.1, *The Review of Economic Studies*, p.1-32, 2003 and see HELLMANN, Thomas. IPOs, Acquisitions, and The Use of Convertible Securities in Venture Capital. *Journal of Financial Economics*, v. 81, n. 3, p. 649-679, 2006.

311 NIGRO, Casimiro; ENRIQUES, Luca. *Venture Capital e Diritto Societario Italiano: Un Rapporto Difficile...*p. 156. For an analyzes of exit provision in VC financing contracts, see SMITH, D. Gordon. The exit structure of venture capital. *UCLA Law Review*, v. 53, n. 2, p. 315-356, 2005.

312 NIGRO, Casimiro; ENRIQUES, Luca. *Venture Capital e Diritto Societario Italiano: Un Rapporto Difficile...*p. 156. According to the authors, this model is similar to the one described by Bernard Black and Reinier Kraakman in BLACK, Bernard; KRAAKMAN, Reinier. A Self-Enforcing Model of Corporate Law, *Harvard Law Review*, v. 109, n. 8, p.1911-1982, 1996.

they are structured to allow the venture capitalist to protect certain interests only by applying specific powers provided by the contracts, which has the function of limiting, as far as possible, recourse to the judicial authority and, in this way, minimizing the risk of reputational prejudices that could arise from the involvement in legal disputes³¹³.

The literature has recently studied in more detail the correlation between the rigidity of a given corporate law regime and the levels of VC investment in a given jurisdiction³¹⁴. Such theory starts from the understanding that corporate law defines the default terms of the corporate contract, allocating cash-flow and control-rights in a certain way³¹⁵. Venture capitalists and entrepreneurs have incentives to change the default arrangements and the standard corporate contract according to their specific needs. Depending on the flexibility of the corporate law of a given jurisdiction, it can facilitate or hinder this process. In this way, a flexible corporate law allows VCs and entrepreneurs to reach the equilibrium on which contract formation is contingent more easily³¹⁶.

On the other hand, a rigid corporate law could create friction in two ways. First, a rigid corporate law may prevent the adoption one

313 NIGRO, Casimiro; ENRIQUES, Luca. *Venture Capital e Diritto Societario Italiano: Un Rapporto Difficile...* p. 156.

314 See e.g. NIGRO, Casimiro; ENRIQUES, Luca. *Venture Capital e Diritto Societario Italiano: Un Rapporto Difficile*; NIGRO Casimiro; STAHL J.R. *Venture Capital-Backed Firms, Unavoidable Value-Destroying Trade Sales, and Fair Value Protections*, *Eur. Bus. Org. L. R.*, v. 22, pp. 39, 2021; ENRIQUES, Luca; and NIGRO, Casimiro. *Corporate Law and Venture Capital in Italy: What Does the Empirical Evidence (Really) Tell Us?*, Oxford Business Law Blog, 16 November 2023, available at <https://blogs.law.ox.ac.uk/oblb/blog-post/2023/11/corporate-law-and-venture-capital-italy-what-does-empirical-evidence-really>.

315 NIGRO, Casimiro; GÖZLÜGÖL, Alperen A. *Building an EU Venture Capital Market: What About Corporate Law?* In: GIMIGLIANO, G. & CATTELAN, V. (eds.) *Money law, capital, and the changing identity of the European Union*. Oxford: Hart Publishing, 2022, p. 169.

316 NIGRO, Casimiro; GÖZLÜGÖL, Alperen A. *Building an EU Venture Capital Market: What About Corporate Law?* In: GIMIGLIANO, G. & CATTELAN, V. (eds.) *Money law, capital, and the changing identity of the European Union*. Oxford: Hart Publishing, 2022, p. 169.

or more contractual provisions³¹⁷. Besides that, a rigid corporate law may generate higher transaction costs, in the form of drafting costs, litigation costs, unenforceability costs, renegotiation costs etc³¹⁸. This is another way on which a rigid corporate regime could prevent venture capitalists and entrepreneurs from cooperating, what could lead to a decrease in the overall volume of VC investments³¹⁹.

Regarding the ways that a rigid corporate law may prevent the adoption one or more contractual provisions, one example is the use of convertible notes in Italy. According to Paolo Giudici and Peter Agstner, it is debatable, under the Italian corporate law system, whether a private company could issue convertible notes³²⁰. In Italy, such instrument was typically used only by public companies, until a reform in the Italian corporate law in 2003, which allowed private companies to issue standard debt securities (*titoli di debito*)³²¹. However, such law reform did not mention the possibility of including a conversion right. In view of this legislative gap, Italian scholars debated whether Italian private companies or SRLs could issue convertible debt notes³²².

317 NIGRO, Casimiro; GÖZLÜGÖL, Alperen A. Building an EU Venture Capital Market: What About Corporate Law? In: GIMIGLIANO, G. & CATTELAN, V. (eds.) *Money law, capital, and the changing identity of the European Union*. Oxford: Hart Publishing, 2022, p. 169.

318 NIGRO, Casimiro; GÖZLÜGÖL, Alperen A. Building an EU Venture Capital Market: What About Corporate Law? In: GIMIGLIANO, G. & CATTELAN, V. (eds.) *Money law, capital, and the changing identity of the European Union*. Oxford: Hart Publishing, 2022, p. 169.

319 NIGRO, Casimiro; GÖZLÜGÖL, Alperen A. Building an EU Venture Capital Market: What About Corporate Law? In: GIMIGLIANO, G. & CATTELAN, V. (eds.) *Money law, capital, and the changing identity of the European Union*. Oxford: Hart Publishing, 2022, p. 169-170.

320 GIUDICI, Paolo; AGSTNER, Peter. Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?), *Eur Bus Org Law Ver*, v. 20, p. 597-632, 2019, p. 27-30.

321 GIUDICI, Paolo; AGSTNER, Peter. Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?), *Eur Bus Org Law Ver*, v. 20, p. 597-632, 2019, p. 27-28

322 GIUDICI, Paolo; AGSTNER, Peter. Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?), *Eur Bus Org Law Ver*, v. 20, p. 597-632, 2019, p 27-28.

Moreover, there is also a debate among Italian scholars regarding the applicable limits to the issuance of classes of quotas with limited or multiple voting rights³²³. According to a law reform occurred in 2012-2017, the articles of incorporation of startups may allow the creation of classes of quotas “within the limit imposed by law”, but it does not indicate which these limits are³²⁴. Therefore, scholars refer those limits by analogy to the Italian law of public corporations, understanding that multiple votes cannot be more than three and that the maximum amount of shares with limited voting rights shall not exceed half the share capital³²⁵.

Regarding the UK VC market, Armour highlights some difficulties that certain mandatory corporate law rules in the UK can pose for the implementation of certain rights typically present in VC investment contracts³²⁶. Among the aspects mentioned by Armour are the fiduciary duties of directors and the principle of capital preservation. According to the author, the fiduciary duty of directors to act in the best interest of the company may create difficulties for directors appointed by VC funds, particularly when exercising their functions in situations where a conflict of interest exists between the fund and the founders. This is because, if a director appointed by an investor acts solely to favor the interests of the VC fund that appointed them, they will violate their fiduciary duty as a director of the investee company³²⁷.

323 GIUDICI, Paolo; AGSTNER, Peter. Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?), *Eur Bus Org Law Ver*, v. 20, p. 597-632, 2019, p. 30-31.

324 GIUDICI, Paolo; AGSTNER, Peter. Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?), *Eur Bus Org Law Ver*, v. 20, p. 597-632, 2019, p. 30-31.

325 GIUDICI, Paolo; AGSTNER, Peter. Startups and Company Law: The Competitive Pressure of Delaware on Italy (and Europe?), *Eur Bus Org Law Ver*, v. 20, p. 597-632, 2019, p. 30-31.

326 ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 150-151.

327 ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 150-151.

The second example mentioned by Armour relates to a clause typically found in VC investment contracts, particularly in the U.S. model: redemption rights, which grant investors the right to require the company to buy back their shares under certain conditions and at a set price (thus offering a kind of guaranteed return to investors)³²⁸. However, according to the principle of capital preservation established in the Companies Act of 1985, if a company does not have available profits to carry out such a repurchase, the shareholder will not have a valid claim for damages in court if the company fails to fulfill the redemption obligation it has contractually assumed. Thus, the redemption right typically granted to VC investors under the contractual arrangements used in the U.S. could not be specifically enforced in the UK due to incompatibility with the principle of capital preservation³²⁹.

The Chinese experience of the recent development of its VC market support the argument regarding the influence of the level of flexibility of corporate law to VC investments. Corporate law rules in China have also undergone reforms aimed at simplifying existing corporate structures to stimulate entrepreneurial activity in the country³³⁰. According to Lin Lin, the corporate form usually adopted by companies in the Chinese VC market is the limited liability company. Recently, China's corporate law was amended to reduce the costs of incorporating companies and foster the development of VC practices in the country. One of the reforms carried out in 2013 was the elimination of the minimum capital requirement for both domestic and foreign companies³³¹. This aspect is also highlighted by Armour, who suggests a correlation between the ease of incorporating companies and the demand for VC investments, mentioning the minimum capital

328 FELD, Brad; MENDELSON, Jason. *Venture deals*. 4. ed. New Jersey: John Wiley & Sons, 2019, p. 93-94.

329 ARMOUR, John. *Law, Innovation and Finance*...p. 150.

330 LIN, Lin. *Engineering a venture capital market: lessons from China*...p. 187-189.

331 LIN, Lin. *Engineering a venture capital market: lessons from China*...p. 188.

requirement found in various European countries as an obstacle to the development of such a market in those regions³³².

According to Lin Lin, another important reform implemented by China was the introduction of a “three-in-one” business registration system, which, since 2015, eliminated the need for approvals from three different government agencies for companies applying for registration, simplifying the business formation process in China³³³. A third significant reform in China’s corporate law context was the creation of a new reporting system in 2014. Through this reform, companies are no longer required to submit annual reports for verification by the national regulatory body³³⁴. According to Lin Lin, these initiatives have significantly reduced the costs and procedures required to incorporating companies, as well as improved the business environment as a whole in China.

B. CIVIL INSOLVENCY REGIME

Another legal aspect for which there is evidence in the literature of its influence on the VC market are the rules on civil insolvency. According to a study by John Armour, the personal insolvency rules can significantly impact venture capital activity³³⁵. Armour analyzed the insolvency rules in eleven jurisdictions, including Belgium, Denmark,

332 ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 150-151.

333 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 188.

334 LIN, Lin. Engineering a Venture Capital Market: Lessons from China. *Columbia Journal of Asian Law*, v. 30, p. 160-220, 2017, p. 189.

335 See ARMOUR, John. Personal insolvency law and the demand for venture capital. *European business organization law review*, v. 5, p. 87-118, 2004. The author also discusses the potential impact of corporate law in times of crisis on the levels of development of the VC market but indicates that the effects of the insolvency regime are potentially more significant.

France, Germany, Ireland, Italy, the Netherlands, Spain, Sweden, the United Kingdom, and the United States³³⁶.

These rules could affect the interest of companies and founders in seeking VC investment—in two ways: (i) *ex ante*, as strict personal insolvency rules could discourage entrepreneurs from creating high-growth, high-risk tech-based companies; and (ii) *ex post*, given that a set of personal insolvency rules that hinder the financial rehabilitation of individuals who have declared personal bankruptcy could economically exclude talented entrepreneurs whose businesses did not succeed due to reasons beyond the founders' diligence and efforts³³⁷.

C. LABOR LAW ASPECTS

The literature also examines the influence of labor law on the development of the VC market. Armour, based on the work of Jeng and Wells³³⁸ and Gilson³³⁹, argues that labor law can impact the demand side of the venture capital market, that is, the entrepreneurs' interest in developing business activities³⁴⁰. One aspect of this relationship concerns the flexibility of labor regimes in different jurisdictions. According to a study by Jeng and Wells, the existence of rigid labor

336 ARMOUR, John. Personal insolvency law and the demand for venture capital. *European business organization law review*, v. 5, p. 87-118, 2004, p. 101.

337 ARMOUR, John. Personal insolvency law and the demand for venture capital. *European business organization law review*, v. 5, p. 87-118, 2004, p. 101-102.

338 JENG, Leslie A.; WELLS, Philippe C. The determinants of venture capital funding: evidence across countries, *Journal of Corporate Finance*, v. 6, p. 241-289, 2000.

339 GILSON, R.J. The legal infrastructure of high technology industrial districts: Silicon Valley, route 128, and covenants not to compete, *New York University Law Review*, v. 74, p. 575-629, 1999.

340 ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 151.

law rules is negatively associated with VC investment levels in the analyzed countries³⁴¹.

Another way labor law could influence the VC market, according to Gilson's study, is through the positioning of courts in each jurisdiction regarding the enforcement of non-compete clauses³⁴². In the state of California, in the United States, as Gilson pointed out, non-compete obligations are typically not enforced by courts. While this might initially seem detrimental, Gilson argues that the greater possibility of information transfer between agents in local markets can benefit the VC market, fostering innovation in general³⁴³.

5. CONCLUSION

This article aimed to explore the relationships and potential implications between law and the venture capital market. Based on a literature review, it examined how law may impact the VC market through three central elements: (i) the availability of capital in this sector; (ii) the existence of appropriate legal institutions to enable the activities of financial intermediaries; and (iii) the existence of a favorable environment for the development of innovative businesses by entrepreneurs.

Regarding the first of these elements, the literature indicates that a country's legal framework can influence the level of capital allocated to the VC sector through three main areas. One of these -though debated in the literature- is the role of state in encouraging investments in this market, particularly through the creation of investment funds

341 JENG, Leslie A.; WELLS, Philippe C. The determinants of venture capital funding: evidence across countries.

342 GILSON, R.J. The legal infrastructure of high technology industrial districts: Silicon Valley, route 128, and covenants not to compete...p. 602-613.

343 GILSON, R.J. The legal infrastructure of high technology industrial districts: Silicon Valley, route 128, and covenants not to compete... p.602-613; e ARMOUR, John. Law, Innovation and Finance. In: MCCAHERY, Joseph; RENNEBOOG, Luc. *Venture Capital Contracting and the Valuation of High-Technology Firms*. New York: Oxford University Press, 2003, p. 151.

dedicated to venture capital. The second area concerns the regulatory framework, which may either incentivize or deter institutional and foreign investors from participating in the VC market. Additionally, the literature suggests correlations between tax law and the level of capital available for VC investments.

The legal aspects related to financial intermediaries in the venture capital market are also addressed in the literature. Studies have analyzed how the legal structures available for organizing investment funds affect their performance, particularly in accommodating the specific characteristics of relationships between final investors and VC fund managers. Moreover, this article highlighted how exit conditions—especially through initial public offerings (IPOs)—play a crucial role in the development of the VC market accross jurisdictions.

Finally, the article examined the role of entrepreneurs. The literature discusses how corporate law, labor law and the civil insolvency regimes can influence the entrepreneurial environment and, consequently, the development of the VC market. With respect to corporate law, scholars emphasize the significance of incorporation costs and procedures, as well as the flexibility of corporate law rules. In the context of civil insolvency, there is evidence suggesting that insolvency laws can either encourage or inhibit entrepreneurial activity in a given country. Similarly, research highlights the influence of labor law flexibility and the enforcement of non-compete clauses on the evolution of venture capital markets.

6. REFERENCES

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