

SEEKING FOR VC INVESTMENT – WHAT DOES MATTER FOR START-UPS?

У ПОШУКАХ ВЕНЧУРНОГО ІНВЕСТУВАННЯ: ЩО ВАЖЛИВО ВРАХОВУВАТИ
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The reconstruction of Ukraine is declared the largest and most comprehensive reconstruction effort since the Marshall Plan after World War II. The Ukrainian government has prioritised private investments. Therefore reforms must be a reflection of progress in improving the business-enabling environment as an attractive destination for economic activities for all parties involved in private investment. In this context, it is important to bring efficient improvements to the role of innovative entrepreneurship. To strengthen the institutions and regulatory framework in Ukraine with a focus on VC funding as a part of Ukraine's reconstruction, it is relevant to consider how far Ukraine's legal framework supports VC-backed innovative start-ups.

We aim to analyse the popular choice of start-up entities in foreign jurisdictions to understand the features of the legal framework that may require particular attention from the point of view of encouraging indigenous VC investee companies in Ukraine.

We consider the form of a Limited Liability Company and a Joint Stock Company as the most appropriate legal entities to incorporate innovative start-ups in Ukraine. But, it is important to customise the appropriate legal variables that might be critical to the demand from VC Funds, investing in Ukraine. Further studies, which take these variables into account, will need to be undertaken to consider the structure of why and how venture capital markets differ with respect to investee firm governance and investee firm performance in the Ukrainian context.

In the sense of determining the contents of innovative start-ups' performance to domestic law, the paper aims to consider the legal structure(s) on the level of innovative start-ups that are most commonly used as vehicles for VC in the USA. We assume that for the purposes of any legislation changes regulating VC, which will be implemented the government would work closely with the business community to ensure a transparent and efficient process, and look to apply an evidence-based legislative design, taking into consideration the practical needs of VC deals to promote early-stage venture capital finance of innovative entrepreneurs in Ukraine.

Key words: venture investment, innovations, private investment, venture fund, startup.

Відновлення України оголошено наймасштабнішим планом з відбудови з часів Плану Маршалла після часів Другої світової війни. Український уряд визначив приватні інвестиції одним із пріоритетів у процесі реконструкції та післявоєнної розбудови. Реформи мають бути спрямовані на покращення сприятливого бізнес-середовища. У цьому контексті важливо ефективно підвищити роль інноваційного підприємництва. Для зміцнення інституцій та нормативно-правової бази в Україні з акцентом на венчурному фінансуванні у відновленні країни, важливо розглянути, наскільки національне законодавство підтримує та забезпечує відповідні умови для ефективної діяльності інноваційних стартапів.

Метою статті – проаналізувати організаційно-правові форми стартапів, щоб зрозуміти особливості правового регулювання, які можуть потребувати особливої уваги з точки зору заохочення місцевих компаній-об'єктів венчурного інвестування в Україні.

Вважається, що ТОВ та АТ є найбільш прийнятними формами для створення інноваційних стартапів в Україні на основі проведеного аналізу правової форми діяльності стартапів, які найчастіше використовуються як об'єкти венчурного інвестування в міжнародному контексті. Важливо налаштувати відповідні юридичні змінні, які можуть бути критично важливими для збільшення попиту з боку венчурних інвестицій, що інвестують в Україну.

У контексті розпочатих реформ даного сектору, важливим видається побудова правового середовища, що стимулює процеси залучення приватних інвестицій до інноваційних підприємств на ранніх стадіях розвитку в Україні, у тісній співпраці уряду з бізнес-спільнотою для урахуванням практичних потреб транзакцій венчурного інвестування.

Також, зроблено висновок, що для цілей поточних реформ, спрямованих на мобілізацію приватних суб'єктів для диверсифікації джерел фінансування та зміцнення національного інвестиційного потенціалу, необхідно скоригувати відповідний механізм правового регулювання інноваційного підприємництва як об'єкта правовідносин венчурного інвестування. Подальшого розгляду потребує питання вдосконалення цивільно-правового регулювання з метою адаптації національних норм корпоративного права до сучасних тенденцій регулювання правочинів з венчурним капіталом на глобальному ринку інновацій.

Ключові слова: венчурні інвестиції, інновації, приватні інвестиції, венчурний фонд, стартап.

The war is triggering new challenges for the Ukrainian government and policymakers to form a new Ukrainian transformation. While Russia's aggression against Ukraine continues to cause untold suffering and destruction, the legal and economic reforms in Ukraine are already taking shape in an international context of Ukrainian recovery and reconstruction.

Recovery should enable Ukraine's private investment and boost nationwide entrepreneurship, support small and medium-size innovative start-ups as an important pillar of the new economic model. The recovery process has to facilitate collaboration between national and international actors, including from the private sector, civil society, academia and local government.

The government is implementing investor-friendly reforms at a faster pace than ever before and the potential role of VC funding in supporting Ukraine's post-conflict reconstruction is high on the policy-making agenda.

There is a hypothesis in empirical research if legal start-up structures are excessively rigid and do not adequately facilitate contracting a venture capitalist over rights to returns and control, this will make the investment less attractive [1]. It is

relevant to consider how far Ukraine's Civil Law regulation is flexible to support VC-backed start-ups in the context of the practical needs of parties.

The war has not slowed the success of Ukraine's IT sector which is seeing 20% growth in 2022. From artificial intelligence, blockchain, FinTech to software development and more, Ukraine has over 300,000 IT specialists, and is at the forefront of developments in the industry, with IT outsourcing Ukraine's third largest export [2].

But another tendency is the incorporation of innovative start-ups in a foreign jurisdiction to the requirements on demand of the supplied VC Fund, for example, US or English law. Allowing that situation has increased the attractiveness of investment in Ukraine-focused funds, but it poses the question of how far returns from successful start-ups will eventually flow out of the country.

As we can see, even though martial law, Ukrainian start-ups have a high level of VC funding in comparison to other countries in Central and Eastern Europe. Since the summer of 2022 a number of VC partnerships based in London and New York have announced new funds to support early-stage invest-

ment in Ukrainian companies. A lot of Ukrainian start-ups are continuing to choose the incorporation of their businesses in the USA and the UK as well. We face the situation described by Rock (2001) in his research: in practice that if domestic organisational forms hinder start-ups ability to contract effectively with VCs, they may opt to incorporate elsewhere, even if the business does not physically move [6].

Obviously, this tendency is a reflection of the lack of appropriate legislation, in part, and commercial impact – the investments by USA VC funds to spur the success of Ukrainian unicorns.

The current discussion in Ukrainian legislation is to bring efficient improvements to innovative entrepreneurship, especially for aims of post-war reconstruction related to raising VC funds in Ukrainian IT innovations, provides for the implementation of legal instruments formed in international practice into Ukrainian Civil law regulation.

The question arises of the possibility of using certain legal instruments taking into consideration how the VC structure alters in certain circumstances of specific legal frameworks – the possible best entity choice depends upon many legal factors. We are aiming to analyse the popular choice of start-up entities to understand the features of the legal framework which may require particular attention from the point of view of encouraging indigenous VC investee companies in Ukraine.

The general model of VC Investment is private investment in start-up in exchange for an ownership stake in the target investee company (most often a minority equity stake) [4]. Venture capital firms aim to boost the value of the start-ups they target with the intention of selling them, or their ownership in them, for a profit. Venture capital firms fund emerging companies that have yet to fully develop. For such early-stage companies, venture capital funding can be essential, especially since they are frequently unable to access traditional debt instruments, such as bank loans or capital markets.

Given that venture capital firms invest early in a company's lifespan, these investments are generally viewed as very risky. However, venture capital firms tend to reduce risk by giving VC funds a high degree of control and monitoring over their investee companies, and use a range of legal mechanisms to this end including board membership, equity stakes, and staged financing using debt covenants to set targets for firms. If a venture capital-backed business is successfully acquired or goes public through an IPO, the firm generally makes a profit, which is then distributed to the investors [3, p. 10].

It is therefore thought that policymakers wishing to foster venture capital markets should pay attention on instruments of corporate law, it must be possible for parties to customize the governing rules on how a start-up can operate.

We examine the choice of organizational structure for VC investee companies startups in the USA.

Limited liability companies and C corporations are the two primary corporate entities in the United States. Venture Capitalist will more than often want to invest in C-Corporations (C-corp). There are structural and tax restrictions that prevent them from owning stocks in other forms of cooperations, or make investing in Limited Liability Company's (LLC) less attractive.

A limited liability company, also known as an LLC, is a type of company organized under an operating agreement, which is a contract between the owners specifying how it will be run and how the economic burdens and returns will be split between the partners. The possibilities for how to structure an LLC are almost endless, which can have some positive as well as negative sides. This makes interfacing with an LLC challenging, because one has to examine the operating agreement (and potentially other contracts signed between the members) to get a handle on how the company is governed. C corporations, by comparison, are more standardized: They share commonalities like stock to represent ownership, are governance by a board of directors, have day-to-day operations handled by officers, etc.

The main features of LLC are: 1. LLCs act as a business entity intended to provide limited liability for protection for founders. Owners' personal assets are protected, and instead, liability for debts and obligations of the business move from the entrepreneurs into the company itself; 2. LLCs offer pass-through taxation; the LLC's owners generally pay personal income taxes on the income of the business

AC corporation is an entity designed to act as an abstraction layer between the operators of the business and the owners of the business, who may or may not be operationally involved. Ownership is tracked by shares, with each share corresponding to a defined portion of control of the business and entitlement to the economic upside of it. Owners are called shareholders. Control rights and ownership may be separate flows through the mechanics and regulation of C corporations. The state of Delaware has a highly developed body of law governing corporations that can lead to a high degree of predictability in the event of a legal dispute.

There are the main characteristics that are common to C corporations: I. C corporations are intended to provide limited liability protection; shareholders are generally not individually liable for the debts and obligations of the company; II. C corporations are assessed corporate taxes on their own profits (and have extensive filing obligations). Shareholders are taxed separately if the company distributes dividends to them (or if it pays them a salary, in the case of employee owners) [8].

Roughly 30% of the firms that switch from LLC to C-corp change structure within 30 days of their first round of VC financing, and over 50% change within 30 days of any VC financing. VC general partners prefer the C-corp form and invest less and/or encourage the firm to switch if it organizes as an LLC. The founder choice may reflect an effort to structure the company to ex ante appeal to VC preferences. There are well-established procedures for organizing and administering VC investments using that form. They include widely used legal templates to set up governance rights and incentive compensation, and an extensive history of case law and industry practices. More importantly, all market participants, even less sophisticated ones, generally accept and understand the C-corp's operations [5, p. 3-4].

As an explanation of the preferable choice of C corporations in context of corporate law, there are some key points the corporate constitution would create for a US-style VC Investment.

Corporation is that mostly VC firms often want preferred shares in exchange for their investment. Preferred stocks provide VC's with additional rights over common stock. So, venture capitalists typically take preferred shares, usually convertible on demand into ordinary shares, whereas the entrepreneur takes 'plain' ordinary shares. Conversion by the VC will of course remove the liquidation preference, and so will only be done where the portfolio company is doing well. Investment agreements usually provide for automatic conversion on a successful IPO.

One particularly troublesome issue is that the theoretical explanations do not fully explain why convertible preferred stock appears to be the financial contract of choice. The indeterminacy has two aspects. On the one hand, the liquidation priority it affords is unlikely to be of much value to venture capitalists, for the same reason as debt finance is inappropriate. A typical start-up firm will have few liquid assets and therefore the returns from liquidation, if the 'downside' outcome eventuates, will be small. Thus it is unclear why the VC does not simply take ordinary stock. On the other hand, in cases where the assets do have some downside value, and liquidation priority may be worth taking, theoretical accounts of the value of convertibility do not distinguish between convertible debt and preferred equity. Thus, we might expect in some cases to see convertible debt, and in others ordinary equity [1, p. 5]. We found the explanation of the instrument of convertible preferred as the main choice in the US in commercial context to

issue a class of preferred shares. LLCs do not issue shares. They can provide a class of interests with preferences but this is more complex to do and increases the legal fees and startup costs. Also, available evidence that US VCs who invest in Canadian start-up companies do not use convertible preferred stock with anything like the frequency observed in their US investments [1, p. 5].

The absence of preferred shares may create difficulties for venture capitalist in Ukraine, shaping the corporate constitution, but the question is what rights that are superior to holders of common stock might be granted as typical holders of preferred shares typically have. These rights are negotiated and vary accordingly, but will include: 1. A liquidation preference that is senior to the rights of the common stockholders to receive distributions of assets in the event of the company's liquidation. This is a multiple of the original investment amount and is returned to the investor before the common stockholders receive any distribution in a liquidation. In addition to the liquidation preference, the investor may also participate in the distribution of the remaining proceeds on an as-converted-to-common-stock basis alongside the common stockholders (participating preferred stock). 2. Price-based anti-dilution protection (typically broad-based weighted average anti-dilution). 3. A seat on the company's board of directors, or the right to be present at meetings of the board of directors. 4. Veto rights over certain company actions, including over: raising subsequent rounds of equity financing or debt; amending the charter or bye-laws of the company; selling, merging or dissolving the company [7]. As we see the main reason for different classes of share is to allow for differentiated rights in the context of protection of investors.

If the particular transaction structure also requires different dividend or capital rights for the different groups then the need for separate classes is made even clearer. Where there is the founders and employees that need to be motivated by a small shareholding or share options. If the company has already completed an equity financing with a VC fund and the value of the common stock has increased, in an early stage company, the employees typically receive stock options. LLCs cannot offer stock options. They can offer a 'profits interest' but again this adds to the complexity and cost.

VC funds holding equity in successful companies typically seek to exit their investments: 1. An initial public offering or direct listing, after which the VC fund can sell its shares on the public market. 2. A sale of the company. If IPO is desired as an exit mechanism, law should not place impediments in the way of the firm's subsequent listing [8]. In the US both options are easier with a C corporation, shares are freely transferable while there are restrictions on the sale of LLC interests. And depending on the exit strategy, the investors may negotiate for more control rights relating to the type of exit. For example, if it is more likely the company will be sold rather than conduct an initial public offering, the investor may negotiate for more control rights over sales of the company.

As we can consider from the USA experience, other factors that impact Civil Law regulation and which may play a role in structuring the form of legal entity of start-ups include tax environment (by enabling the retention of capital gains from share sales), insolvency law (to the degree that it protects entrepreneurs against the more severe effects of firm failure, and employment law (in terms of how far it enables flexible hiring and firing and allows employees to move between firms without the constraints imposed by restrictive covenants).

As we've already stressed, it is common for start-up firms to make use of the C-corporation form, notwithstanding that these are less flexible than forms designed specifically for small businesses, such as LLCs. We considered LLC and JSC as most appropriate legal entities to incorporate innovative start-ups in Ukraine.

The key considerations that JSC or LLC should be recognized as direct organizational and legal forms of entities that carry out relevant activities. It should be borne in mind that

persons who create a legal entity that will carry out venture capital entrepreneurship, have the goal of obtaining profit from such activities, in case of a negative result of scientific and technical developments, they are interested in their own liability to creditors solely within the value of their contributions (Article 140 of the Civil Code of Ukraine – LLC) or to the extent of the value of the shares they own (Article 152 of the Civil Code of Ukraine – JSC).

But the question of choice of legal entities in the context of reform is wider than just the mechanism of adaptation LLC and JSC to the legal requirements of international VC. The key consideration should be to assess the efficient legal changes to help innovative small VC-backed start-ups operate in that framework to able to create jobs, prosperity, and economic growth efficiently across the country.

To adapt Ukrainian legislation to the requirements for proper venture capital investments in the innovation sector, we propose to formulate some additional legal requirements for start-ups entities.

Start up might be established in a foreign jurisdiction, but company must have a permanent establishment in Ukraine. The argument in favor of keeping VC funds within Ukraine, stimulating the development of Ukrainian innovative enterprises and enterprises of foreign founders who have decided to operate in Ukraine, focusing VC funds on finding potentially successful projects and, as a result, deepening cooperation between the business environment and innovation infrastructure entities in the development of national startup projects.

There is also practical evidence of the economic efficiency of this rule – the empirical research provides an unbiased assessment of the economic value generated by private capital-backed businesses in the UK today. The fundamental findings demonstrate that VC-backed companies contribute significant economic benefits to the UK economy [3].

The requirement for the start-up to carry out innovative activities is important, as such entities, as a rule, are deprived of the opportunity to raise funds from other sources of financing in Ukraine at the initial stages, and therefore VC funds are almost the only reliable source of funds for the development and further commercialization of the developed innovations, struggling to survive of their innovations in their early years of economic activities. The Fund is expected to invest in companies that are less than seven years old from the date of their first commercial sale. However, there are exceptions for 'follow-on' investments and where an established company is looking to raise a significant amount of capital to enter a new product or geographic market, or for example under unexpected circumstances (for example, a war), the company doesn't have sources for economic activity in Ukraine, but there is a high demand for its scaling up on global markets. But there couldn't be exemptions, the rule is that the investee company is unlisted and it is considered a high-risk investment.

In addition, we believe that implementation of offered rules will help to solve the current situation in Ukraine when VC funds invest not in innovations, but in their own projects, for purposes to optimize the taxation of the organization that created the respective VC Fund.

Providing this analyse we noticed that the legal form of entities for innovative star-ups offers a wide range of sources, types, and styles of legal instruments to meet many different needs of the real practice of VC. It helps us to conclude that for purposes of current reforms to mobilize private actors and financing institutions to diversify sources of funding and strengthen national investment capacities, there should be adjusted an appropriate mechanism of legal regulation of innovative entrepreneurship. In the context of VC demand, existing forms of LLC and JSC in Ukraine are suitable for incorporating innovative economic activities. Further consideration needs to be done for adjusting the Civil law regulation to be able to customize national corporate constitutions in the context of the implementation of the current trends of VC deals on the global market of innovations.

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