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## VENTURE CAPITAL INVESTMENT AND CIVIL LAW: CHALLENGING FOR UKRAINE IN AN INTERNATIONAL PERSPECTIVE

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*The sudden Russian attack in 2022 dramatically affected many facets of the Ukrainian economy as well as the global economy, prompting worry that the war would stop flows of venture capital. Today Ukraine is not only fighting for freedom. Ukraine continues to implement an ambitious reform agenda and look for ways to support investment into our economy. It is important time for economic of innovations and venture investment in Ukraine. To support this, the Ukraine Redevelopment and Recovery plan that was initiated by the Ukrainian Venture Capital and Private Equity Association (UVCA). This plan aims to open the Ukrainian venture capital (VC) market to investors from all sectors and countries of the world who are supporting Ukraine and actively joining projects for the Ukrainian development.*

*It is expected to lay the foundation of the framework of the legal regime fostering fast recovery and economic growth after the war reconstruction. Given the scale of Ukraine's losses, it's obvious that Ukraine needs additional help aside from macroeconomic support, among that – joint investments initiated by the private sector in Ukraine. The highly-developed market of VC investment might be critical to the country's recovery and transformation.*

*The issue of how the correlation between the legal framework that helps attract finance into Ukraine and its leakage out of the country under the current circumstances and previous obstacles to VC investments is an important one, and difficult to regulate.*

*In context of recent legal reforms in Ukraine, our focus on legal framework of VC Investments in the economy of recovery and reconstruction.*

*A vast body of research has been carried out to investigate the legal factors which are conducive to VC Investments, and that may better explain the differences in the degree of development and performance of VC transactions around the world. However, there has only been a limited effort in the legal literature to systematize what is known about the institutional factors that spur VC Investments in Ukraine. This paper tries to close that gap by providing useful legal and actionable insights that might assist to raise VC Investments through understanding current tendency of VC deals in the UK. The base is the empirical research of the existing literature on the institutional and related determinants of VC in the UK.*

*The aim of this paper is also to propose interesting avenues for future research on the VC investment process in Ukraine with an outline of how venture deals can be structured. The article also determines the peculiarities and obstacles of applying the common law to VC Investments under domestic legislation.*

**Key words:** *venture investment, innovation, private investment, venture fund, startup, reconstruction.*

### **Сітченко Ганна. Венчурне інвестування інноваційної діяльності: правові виклики для України в міжнародному аспекті**

*Раптовий напад Росії у 2022 році кардинально вплинув на багато аспектів української економіки, а також на світові економічні процеси, викликавши реальне занепокоєння у світі венчурного капіталу. Однак сьогодні Україна бореться не лише за свободу. Україна продовжує впроваджувати амбітну програму реформ. Це важливий час для економіки інновацій та венчурних інвестицій в Україні. На підтримку цього був розроблений План відновлення України, ініційований Українською асоціацією венчурного та приватного капіталу, що*

має на меті відкрити український ринок венчурного капіталу для інвесторів з усіх секторів та країн світу, які підтримують та активно долучаються до проєктів розвитку України.

Очікується, що це закладе основу правового режиму, який сприятиме швидкому відновленню та економічному зростанню. Враховуючи масштаби втрат, очевидно, що Україна потребує додаткової допомоги, зокрема спільних приватних інвестицій. Високорозвинений ринок венчурних інвестицій може мати вирішальне значення для відновлення та трансформації країни.

Питання співвідношення між законодавчою базою, яка сприяє залученню фінансів в Україну, та їх витоком з країни за нинішніх обставин і з попередніми перешкодами для розвитку венчурного інвестування в Україні є важливим і важко регульованим, тому ми зосередили увагу на питаннях цивільно-правового регулювання венчурних інвестицій в аспекті їх потенціалу в національних економічних процесах відновлення та реконструкції.

Було проведено багато досліджень, присвячених вивченню правових детермінантів, які сприяють венчурному інвестуванню, і які можуть краще пояснити відмінності у ступені розвитку та результативності венчурних договорів у різних країнах світу. Однак у юридичній літературі зроблено лише незначні спроби систематизувати те, що відомо про інституційне середовище національних венчурних інвестицій. Дана стаття намагається заповнити цю прогалину через розуміння поточних тенденцій венчурного інвестування у міжнародному аспекті. В основу роботи покладено емпіричне дослідження літератури щодо інституційних детермінантів венчурного інвестування в англійському праві.

Мета статті – запропонувати напрямки для майбутніх досліджень процесу венчурного інвестування в Україні у фокусі розпочатих реформ. У статті також визначено особливості та перешкоди застосування загального права до венчурних інвестицій у вітчизняному законодавстві.

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

The law and finance literature have made evident that it is no easy task to determine the optimal institutional framework for venture capital investments, let alone understanding how to address existing shortcomings, especially in the context of the needs of war and post-war economics. It's important to develop proposals based on the practical VC market needs, in terms of the "considerable divergence between the law and the practical reality" [1] that currently exists.

Academics and practical lawyers have effectively investigated the strengths of the venture model, played by legal institutions and the legal framework in these jurisdictions. The structure of VC investment has in recent years received considerable attention (Armour, 2002 [1]; Armour and Cumming, 2006 [2]; Cumming, 2014 [5]; Armour, Bengtzen and Enriques [3], 2017, Gompers and Kaplan, 2022 [6]).

At the same time, the main question is what theoretical ideas and practical regulations from foreign jurisdictions might be functional in the domestic legal framework, implemented in adapted form, in the Ukrainian context, and the impact of particular regulatory changes for the design of venture investment deals in Ukrainian economic recovery.

Often Ukrainian business prefers to use English law clauses to venture deals. Investors do not like investing in unfamiliar structures as it increases their legal due diligence requirements and creates risk. As pointed out by Berkowitz et al. in the last three decades "many countries borrowed from different legal systems, not infrequently in an attempt to signal to foreign investors from different countries that they comply with their domestic legal standards. ... Yet, the results of these efforts have been mixed" [4]. The question is to what extent the applied mechanisms will be recognized by Ukrainian courts, and how useful such provisions will be in a case of a breach.

Of course, national law at this stage of development is significantly inferior in the availability and sophistication of the relevant instruments for structuring venture transactions, but it cannot be denied that the legal system is developing, regulation is being detailed and is improving and already now there is a set of legal instruments that allow concluding venture deals, where it makes sense to specify national law as applicable law.

In the sense of being able to determine the contents of fund performance to domestic law, the question is what legal structure(s)

are most commonly used as vehicles for venture capital funds? Venture capital funds in the US and UK are typically structured as limited partnerships with the ultimate investors operating as limited partners, thereby giving them legal protection in the event of the failure of the fund, with the general partner (in effect the fund's managers) assuming the risk of failure. VC funds, in turn, typically exercise 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. Funds are able to tolerate a significant failure rate among entrepreneurial start-ups by generating exponentially high returns from a small number of successful investments, which may be realised via IPOs and/or trade sales.

Empirical studies show some key differences between UK-style and US-style transactions, for example, in terms of investor protections, which can be understood as responses to agency problems inherent in the financing relationship. Agency costs and information asymmetries play a central role in shaping the contracts used to set up limited partnerships [5].

The Ukrainian Civil Code lacks an analogue to Limited Partnership for VC Investments. A foreign investor is granted the right to enter into a joint venture with a Ukrainian partner, formally referred to as «a joint activity agreement», but it is worth delving into tax and corporate law regulation in a response for agency costs to understand the actual impossibility of this instrument.

Even ignoring the fact of tax obstacles, this form significantly limits the change of parties to the agreement and the management of the fund, any change to membership creates legal complexities. Firstly, in such a fund, the circulation of participation rights is significantly more difficult, since the change of a participant or their withdrawal is a change in the person in the obligation, which is fraught with difficulties. Secondly, it is more difficult to organize management within the framework of an agreement, there is no established template for board membership or the operation of the board's powers of oversight and control, as is the case with corporations.

In practice, when choosing the legal form of a venture fund, investors and managers have the opportunity to choose not only between national organizational and legal forms, but also between foreign ones. A relatively free choice of jurisdiction is possible insofar as, the venture fund does not conduct entrepreneurial activities (except for the direct transfer of funds). As a domestic law creates significant barriers to using the Limited Partnership form for venture capital funds, then the practice shows a fund may simply be incorporated in a foreign jurisdiction, for example US or English law. As Ukrainian law allows a foreign law to be chosen for the investment VA, if at least one of the parties is non-resident. To the extent that domestic organisational forms hinder their ability to contract effectively with VCs, they may opt to incorporate elsewhere, even if the business does not physically move [8]. As a result, the absence of Limited Partnership in the national jurisdiction makes it difficult, but does not prevent the investor from creating a fund that is incorporated in foreign jurisdictions, which to a certain extent exacerbates the phenomenon of jurisdictional competition in the area under consideration.

The logic of the same argument may be extended to the choice of state of incorporation for start-up firms seeking to raise venture finance. But the next question arises here if a VC fund recovers their investments through a listing in another country, what results does it bring for Ukrainian Innovation market? Allowing this option might increase the attractiveness of an investment for the VC firm, but it poses the question of how far returns from successful start-ups will eventually flow out of the country.

Armour emphasizes that here legal entity structures are excessively rigid and do not adequately facilitate contracting with a venture capitalist over control rights and the balance of ratio risks, this will make the investment less attractive. The measures that stimulate demand are likely to produce a greater return on reform energies than changes designed to foster supply [1, p. 20].

This has important implications for VC Investment, suggesting that law reform efforts designed to stimulate venture capital finance in Ukraine should be directed at the structure of the optimal corporate

form of investee company in VC transactions (through the organisational structures available to entrepreneurs seeking to incorporate their businesses in Ukraine), rather than the absence of LP as a supply side of VC (anyway, the impact will be felt through the design of by foreign business entities used by venture capitalists to structure their funds as the practice shows).

To be more precise, in Ukraine, a range of mandatory rules of company law may create difficulties for venture capitalists. As we have seen, the legal structure of venture capital investments is something that is primarily contractual. The starting point is a model of what venture capital investment involves, derived from empirical studies in the US. The venture capitalist is a financial intermediary, who raises funds from end investors which are then used to finance small entrepreneurial firms. The contracts between the venture capitalist and the investee firms have complex terms which can be understood as responses to agency problems inherent in the financing relationship [1, p. 1]. Would Ukrainian law allow the Common law system to cover everything through the VC Investment agreement (VIA)? For example, we can write everything down, but in case of a breach, is there enough practical powers and legal mechanisms to convert the VIA to enforce this action set out in the VIA? The further focus on the legal features under Civil law regulation in Ukraine and how useful such provisions will be is debatable in the event of a breach. In good times legal protections do not matter but they can do other times.

Venture capital will invest in new companies, many, if not most, of which will not yet be having a profit, which can be used to make interest payments on debt, and it is difficult to predict how much return (if any) will be generated. Start-up firms with developing new technologies are looking for VC investments is that many lack liquid assets. The key feature that allows the financial contract to work is the ability of the investor to take control of the assets should a default occur which makes credible their threat to enforce in bad states [7].

However, since the businesses are nascent, venture capital investors will take a disciplined and holistic approach in evaluat-

ing not only the viability of the business idea, but also the motivation and background of the entrepreneur, which is not amenable to enforcement by an investor.

To be more precise, "it is impossible for the entrepreneur to alienate the human capital. However, by making greater cash flow rights vest over time, the entrepreneur can be 'locked in' to the business. This is typically achieved through option vesting schemes, whereby the executives are given options to purchase stock provided that they remain with the firm for a fixed period. Furthermore, entrepreneurs usually also sign covenants not to compete, which apply should they cease to work for the firm"[1, p. 7].

More notably in this situation, taking into consideration that VC as an asset class is different, to give the investors desired commercial effect for those circumstances this particular feature – a ratio of risk – has to be structured in a particular way to give more control than it normally would.

There is a tendency that Investment agreements to provide for a wide range of control rights to be given to the venture capitalists as a particular structure between general partner (GP) and limited partners (LP), between managers of the Fund and investors of the Fund, agency costs between the VC Fund as the whole and the investee company, the managers of investee company.

It should be noted from the outset how these key elements of a venture deal are based on Ukrainian legislation. How the domestic legal rules work to frame the whole concept – shareholder rights, managers rights, creditors rights. Are these features correctly framed to facilitate this type of investment right now in an international context? A serious consideration is whether the law is flexible enough in Ukraine. It is therefore necessary to consider which provisions of English Law do not apply and to check carefully that those could be properly carried on under the whole concept of Ukrainian Civil law regulation. Also, it is important to identify those that would be applicable, but with specific exclusions and amendments to reflect the domestic requirements of VC investment, as well as other appropriate changes for financial flow to the investee company that need to be covered by the design of VC deals.

The Law of Ukraine "On stimulating the development of the digital economy in Ukraine" adapted the following elements of the system of common (English) law: convertible loan, option, liquidation preferences, warranties, and indemnities. However, the question of the feasibility of using elements of English law within the framework of Ukrainian jurisdiction immediately arises, because the legislator justifies the innovation by the fact that it will allow all market participants, including foreign investors, to invest on clear terms through the familiar mechanism, is it really so?

Thus, for example, Article 29 of this Law established the concept and features of a loan agreement with an alternative obligation.

Therefore, if we proceed from the legal regime established in Ukraine when concluding such a contract, the above obligations can be implemented only voluntarily if both parties in the future show a desire to fulfill them. Based on the legal nature of the loan agreement, the investor will definitely be able to demand the return of funds, at the same time, the obligation to transfer the debtor's shares (parts) into the ownership of the creditor against the debt cannot be forcibly implemented, since the turnover of securities is regulated by law in Ukraine and for the transfer of shares into the ownership of a third party requires a legal basis – a relevant sales contract concluded in accordance with the requirements of the law. It is not known whether the debtor will increase its own authorized capital, it is assumed that the final decision is made depending on the valuation of the startup at the time of loan repayment, which is an additional risk for the investor. The creditor will not be able to legally force the debtor to increase its authorized capital, since such an obligation cannot be realized by the debtor himself, it depends on the corporate decision of his shareholders (participants).

In order to achieve the necessary result for a venture investor, practitioners are suggested to use termination by offsetting counterclaims under Art. 601 of the Civil Code of Ukraine. In particular, for joint-stock companies at the regulatory level, it is possible to pay for such shares by offsetting counterclaims with the issuer, if the issuer has mon-

etary obligations to the shareholder (future shareholder) upon additional issuance of shares. For limited liability companies, such rules are not established. Still, there is no prohibition, so it can be assumed that counterclaims can also be counted on the basis of the general provisions of the law of obligations. Therefore, choosing such a method of venture capital investment in local Ukrainian startups, one should not reject the situation that in the end the investment can be transferred exclusively as returning an ordinary interest loan.

The primary purpose of the representations and warranties is to provide the investors with a complete and accurate understanding of the current condition of the company and its previous history so that the investors can evaluate the risks of investing in the company prior to subscribing for its shares. Investors expect those providing representations and warranties about the company to back them up with a contractual obligation to reimburse them in the event that the representations and warranties are inaccurate or if there are exceptions to them that have not been fully disclosed.

Accordingly, in the absence of fraud, venture investors are unlikely to look to the investment agreement warranties as a principal remedy if something goes wrong in the investment. Instead, they will look first to the various mechanisms included in the documentation designed to assist them in an underperformance situation and, where appropriate, will seek to bring about a suitable change in management. This is not to say that the investment warranties do not really matter or should not be taken seriously – they are particularly important in ensuring that any information known to the managers which may be relevant to the investment decision is flushed out [9, p.121].

For convenience, in the summary which follows the investment agreement warranties do allocate risk contractually, but it is important to bear in mind that they usually provide a very limited remedy in this context, as there are several reasons why a venture investor is likely to choose not to bring a warranty claim against a manager under the investment agreement, even if there is a valid potential claim. In some cases, "the managers may still be valuable

to the business. Unless the circumstances surrounding a warranty breach are so gross as to call into question the confidence which the private equity investors can place in the managers, the fact that there is a potential warranty claim against the managers does not, in itself, preclude the fact that the managers may still be of continuing value to the business. In an underperformance situation, for example, a relevant manager may still be the best person (or part of the best team) to turn around the investment. In that situation, bringing or threatening to bring a warranty claim against that valuable manager or management team would be a material disincentive, and could have an adverse effect on the present and future prospects of the investment itself as a result" [9, p.121].

As the other example, importance of reputational risk to the venture investor. There can be adverse consequences for the investor if it becomes known that it is too readily prepared to bring a claim against managers (at least in the absence of fraud). Not only is there a risk that this would suggest that they had backed the wrong managers, but it may also make future management teams and their advisers more hesitant to deal with that Venture Fund (or, at least, to give warranties to it), and accordingly favour a less trigger-happy rival investor in negotiations on future deals. This would be the case, in particular, where there was a suspicion that the VC investor was simply trying to recover its investment because the business had failed (as opposed to any fraud or similar gross impropriety surrounding the giving of the investment agreement warranties).

One very important aspect of the warranties in the investment agreement is the desire on the part of venture capitalist to be able to proceed against one manager without having to proceed against all of them (or, for example, to be able to compromise or release a claim against one manager without affecting any claims against the others). So, in the case of the implementation covenants of warranties in Ukrainian context, it will work to elicit disclosure, but for purpose of allocating risks, it is more for how the corporate governance might be design in the venture deals, based on the given information.

We now turn to consideration of corporate governance and how currents changes

may affect venture capital investments in Ukraine. For, example the VC Fund appoint the managers to seats in the board of the investee company to observe what they do – it's not like a normal listing company where the ownership and control are very clearly separated. For these reasons, our intention is to set out the general overview of corporate governance with the focus on control rights under Ukrainian legislation.

Notwithstanding the fact that in many situations, VC investors have a majority equity interest, it is still usual to find express provisions in the investment agreement dealing with the ability of the investors to appoint and remove directors. As a matter of general Ukrainian company law, shareholders with a majority of the votes available in the general meeting would have the power to do this in any event.

The position varies more widely where investors have a minority stake. "Some investors will insist on a hard right to appoint or remove directors being granted in favour of the investors" [9, p. 133]. The next example should not be taken as a representing instance. The each case will be different and will need to be handled on an individual basis, but it is always a question of bargaining power. Case in point, the investment agreement will enable the venture investors will have the right to appoint one director (the investor director), who will have the same rights as all of the other directors of the investee company as long as the investor holds no less than 5% of the issued shares in company.

In addition to the right to appoint a director, for so long as the investor holds any shares in the company, the Fund will have the right to appoint one board observer.

On January 1, 2023, the Law on Joint Stock Companies came into force, aimed at adapting national legislation to international corporate governance practices. One of the most important changes is the right of Ukrainian companies to establish boards of directors, which are an alternative to supervisory boards, which in Ukraine do not always meet expectations. In practice, in addition to the general meeting of shareholders (participants), most Ukrainian companies have only an executive body – the board, management board or a single director.

A positive step is the possibility of applying an alternative structure of cooperative management, which combines the functions of supervision and management in one body – the board of directors, which includes executive directors who manage and non-executive directors who control the executive directors. Thus, shareholders on the board of directors have levers of effective control over the business (there is a readiness to step back from operational management but a strong tendency to have access to operational information, close communication with directors, and the ability to intervene at a critical moment). In contrast, in a system where the supervisory board is separated from management, supervision is mostly delayed, which reduces the effectiveness of the operational response, which is of particular importance for venture capital investment.

A venture capital investor will normally subscribe to a preferred class of shares. These are shares to which certain rights attach, that are not shared by ordinary shares held by the founders and others. It's obvious, VCs require additional protective provisions and consent rights because "in most cases, they are investing much larger sums than the founders (whose investment usually takes the form of good ideas, time, and a small amount of seed money) and at a much higher valuation." Alternatively, this can be compensated for to an extent by creating special rights for certain shareholders in the investment documentation.

The purpose of these rights is to protect the investors from the company taking actions, which may adversely affect the value of their investment, take consent rights, for instance. The venture capital investors normally require that certain actions cannot be taken by the company without the consent of the holders of a majority (or another specific percentage) of their class or series of shares (investor majority). Sometimes these consent rights are split between consent of an investor majority, consent of the investor director(s) or consent of the Board. Typically what requires investor majority consent and what requires investor director consent would relate to major changes in the company such as changes to share classes and share rights, changes to the company's capital structure, issuance of new

shares, mergers and acquisitions, the sale of major assets, winding up or liquidating the company, declaring dividends, incurring debts above a certain amount, appointing key members of the management team and materially changing the company's business plan. Whereas operational matters that need more urgent consideration by the Board would continued to be left for board consent.

It is worth showing several examples of practical applications that demonstrate the demand for boards of directors in Ukraine.

First, the shareholder retains control by delegating management. The venture capital investors will also have less control over the company's day-to-day operations than the founders, who typically remain closely involved in management. But by delegating operational management to directors, shareholders or their representatives can join the board of directors. This gives them the opportunity to participate in real-time discussions of important company issues, up to and including the veto right to directors' decisions. It is important that such participation is not postponed until the next supervisory board meeting.

Having executive directors on the board alongside shareholders balances management and control. A shareholder does not have to be a permanent CEO and deal with day-to-day operational matters. At the same time, the shareholder retains the ability to promptly correct the work of the directors.

Second, this corporate governance system is familiar to foreign investors. As noted above, investors structure Ukrainian venture-funded business projects through a foreign country to have better protection of property rights and access to an efficient legal system and alternative dispute resolution, which includes familiar and well-established business practices. It is important for investors to find a balance that allows them to effectively monitor and guide management, but without overly interfering with day-to-day operations.

The board of directors helps to achieve this balance through fruitful cooperation between the CEO and other executive directors together with investor representatives.

The third argument – the introduction of the board of directors is an important step towards harmonization of Ukrainian legisla-

tion on contractual regulation in the field of corporate law, as it simplifies the approval of contracts for VC Investments.

Companies hold general meetings from time to time to agree with shareholders on various business issues, including routine ones. The more shareholders there are, the more difficult it is to approve, as shareholders may be unavailable or have different views on the transaction, which can delay or even derail the company's transactions. Failure to approve and therefore failure to execute a deal means very often losing an opportunity for the company. And the execution of a transaction without approval creates a risk for the company (challenging the agreement) and the director (exceeding the authority). This dilemma can be solved by appointing several shareholders to the board of directors. They will promptly approve major transactions for management, except

for the most critical ones, for which a meeting with the participation of all shareholders will be convened.

The structure of English corporate law, as we have seen, has tended to permit shareholders to control many aspects of the managerial agency problem without the need for litigation.

Bearing these points in mind, the current legislation changes presented in this review suggest there is a case for looking again at the way the legal framework of Civil law affects VC Investment more widely than just implementing changes in the law "About joint investment institutions". Understanding the whole concept of Civil Law is particularly valuable in relation to shareholder rights, managers' rights, and creditors' rights for framing the legal institute of venture capital investment that reflects the needs of the practice and global transactions trends.

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