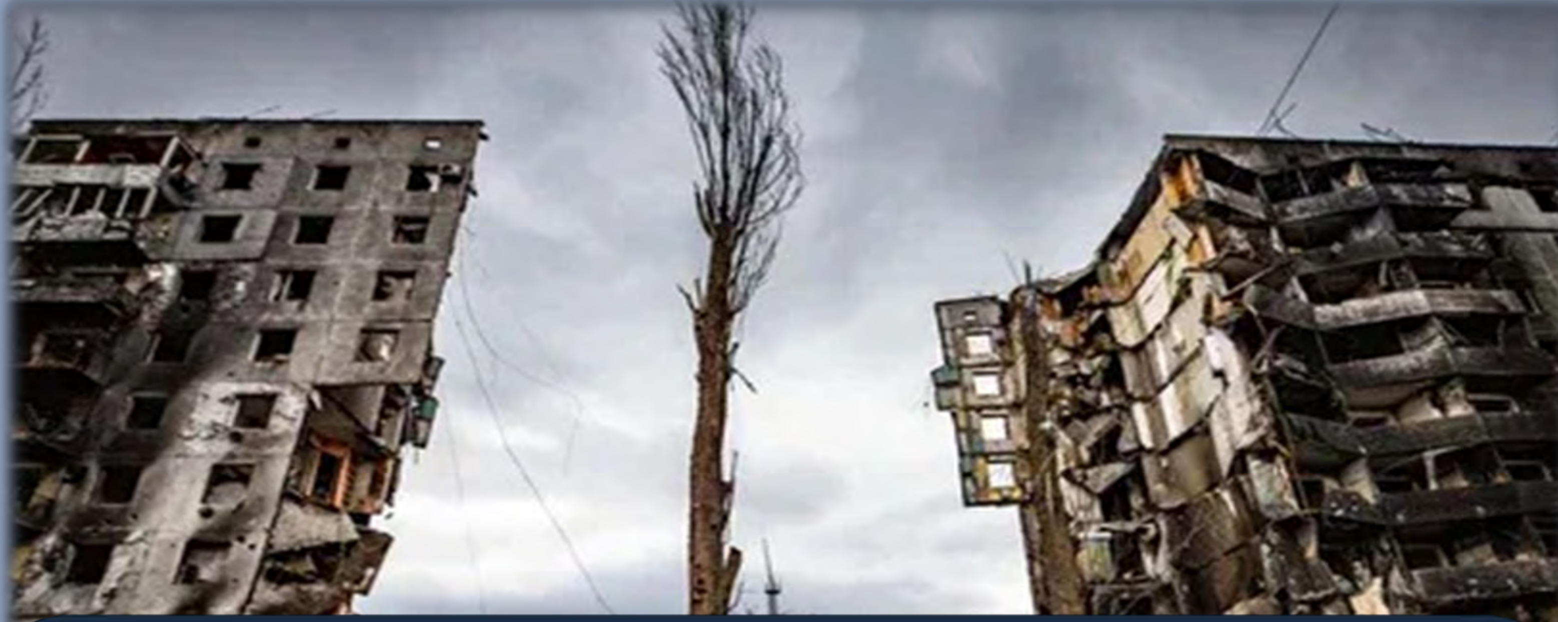
CBR



The Legal Framework for Venture Capital in Ukraine

Simon Deakin, Francesca Farrington and Hanna Sitchenko

December 2024

Centre for Business Research, Judge Business School

11-12 Trumpington Street, Cambridge, CB2 1QA

Tel: +44 1223 765320 Fax +44 1223 765338

Email: enquiries@cbr.cam.ac.uk |https://www.jbs.cam.ac.uk/centres/business-research-cbr/

CBR

The Legal Framework for Venture Capital in Ukraine

Simon Deakin, Francesca Farrington and Hanna Sitchenko*

Centre for Business Research, University of Cambridge

December 2024

* Respectively, professor, Faculty of Law, and Director, CBR, University of Cambridge (s.deakin@cbr.cam.ac.uk); Lecturer, School of Law, University of Aberdeen, and research associate, CBR, University of Cambridge; (francesca.farrington@abdn.ac.uk); and postdoctoral research fellow, CBR, University of Cambridge (hs841@cam.ac.uk). The authors contributed equally to the report and are listed alphabetically. We are grateful for feedback from Elizabeth Pollman, Casimiro Nigro, and participants at a workshop held in Cambridge on 2 July 2024. Mona Jebril and Rachel Wagstaff provided invaluable advice on formatting and presentation. We thank the Cambridge Endowment for Research in Finance for funding the research.

The Legal Framework for Venture Capital in Ukraine

Executive summary

Establishing a thriving venture capital (VC) ecosystem has been identified as a principal objective for Ukraine's reconstruction. This report assesses how far Ukraine possesses a legal and institutional framework which is conducive for VC growth and development.

In its original US form, VC has developed via a specific transactional architecture, which grants investors a high degree of protection against downside risk while enabling them to profit on the upside when startups succeed. Flexibility in the drafting of corporate charters and related agreements is a key feature of this model. The malleability of US corporate and commercial contract law is thus of central importance, alongside the availability of legal instruments which funds use to protect their interests, including convertible preferred stock and liquidation preferences. Favourable rules in tax, bankruptcy and employment law, and an active market for IPOs underpinned by an investor-friendly corporate law, are also features of the US model.

In common with other countries in Europe and around the world, Ukraine has made a number of legal changes with a view to encouraging VC and enterprise-based innovation more generally. These include a new bankruptcy law from 2019, reforms to the joint stock company law in 2021, and a significant liberalisation of employment law with effect from 2022. In addition, a special legal regime for IT-focused startups, the Diia City free zone, provides for many of the transactional devices thought to be important for VC development, including non-disclosure agreements, non-competes, convertible loan notes, option agreements, and representations and warranties, as well as VC-supporting tax and employment law rules.

Potential legal obstacles to the VC sector nonetheless remain. There is a degree of uncertainty over how far transactional structures characteristic of VC, such as convertible debt, can be made to work in the wider context of Ukrainian corporate and commercial law. Shareholder agreements, similarly, may not be straightforwardly enforceable where they depart from companies' articles of association and mandatory provisions of corporate law.

In practice, any shortcomings of domestic Ukrainian law may be overcome through the use of foreign law to underpin corporate and financial arrangements. It is normal for Ukraine-based startups to incorporate in the US state of Delaware or to be controlled via a US-based holding company. The cross-border structure of VC is familiar to legal practitioners and has been successfully used in other European countries to help develop local VC ecosystems.

The wider institutional environment in Ukraine remains an obstacle to the development of a domestic VC sector. Progress towards the rule of law has been slower than elsewhere in east central Europe over the past decade. VC-friendly legal structures, designed to promote innovation, have been used as tax avoidance devices in non-innovating sectors, such as real estate, and to conceal corporate ownership.

In the short term, reliance on foreign law to organise VC may be a practical option for Ukraine, as it has been elsewhere in Europe. In the medium to long term, building a viable VC ecosystem capable of generating knowledge spillovers will require the onshoring of legal and professional services. Reliance on workarounds and carveouts to support VC carries the risk that these structures will be used for ulterior ends. Exempting VC from general rules of law may run counter to the goal of enhancing trust in the legal system.

1. Introduction

The potential role of venture capital in supporting Ukraine's post-conflict reconstruction is high on the policy-making agenda, with a number of legal reforms recently introduced with the aim of promoting VC startups and investments. Since the summer of 2022 a number of VC partnerships based in London and New York have announced new funds to support early-stage investment in Ukrainian companies. The Ukraine Venture Capital and Private Equity Association (UVCA) issued a Redevelopment Plan which was discussed at the Davos World Economic Forum of January 2023, and the Ukraine Reconstruction conferences which took place in London in June 2023 and in Berlin in June 2024 also prioritised VC as an area for development.

With the focus on VC funding as a part of Ukraine's reconstruction, it is relevant to consider how far Ukraine's legal framework supports VC. It is generally recognised that the legal framework for VC financing is an important variable in explaining its incidence and effects across countries. VC has a distinct transactional structure, in which funds act as information intermediaries, linking ultimate investors (ranging from pension funds, mutual funds and wealthy individuals) to high tech entrepreneurial firms. By pooling expertise, VC funds can help overcome agency costs, generate learning externalities, and diffuse risks associated with innovation. This transactional structure has legal underpinnings which can be found in most jurisdictions albeit with some variations and modifications.

The normal legal structure of a VC fund is that of a limited partnership. The investors enter 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, so constituted, typically exercise a high degree of control and monitoring over investee companies. This model has been described as one of 'contingent control': funds use a series of mechanisms, including various types of convertible shares and loans, to enable them to minimise downside risks while maximising the scope for positive returns in the event of firm success. Control can also be exercised through board membership and observer rights, while, beyond the terms of corporate charters, shareholders' agreements can provide for veto rights and liquidation preferences. In each of these cases, the legal form of the control mechanism is thought to be critical to its practical operation.

Another feature of VC funds is associated with the portfolio form, through which investments in a series of startups are pooled. The portfolio structure creates an implicit 'tournament', with startups competing for financing over sequential stages of the funding cycle, beginning with initial 'seed' financing and early-stage financing before moving on to further rounds and culminating in either a successful exit or a liquidation. In addition to diffusing risk, the portfolio structure helps the managers of the funds to acquire and share generic expertise in firm governance and oversight. It also means that firms can tolerate a high failure rate; even when, as is normal, the majority of startups in a portfolio fail, exponentially high returns from a small number of them, in the nature of a 'power law' distribution, may be realised. Exit via an IPO or trade sale enables the fund to cash out its holdings and return value to the ultimate investors.

Exit via an IPO has been variously explained as enabling the VC fund to recoup its initial investment while retaining a post-flotation role through a retained equity stake and board membership. A continuing role for both the fund and the founder-entrepreneur can be regarded as a signalling device or credible commitment to the effect that downstream risks are not being concealed from future investors. It also enables entrepreneur-founders to retain a controlling role in the management of the firm, which would not be so straightforward through a trade sale leading to the integration of the startup into a larger corporate structure (Black and Gilson, 1998). If this thinking is correct, rules of corporate law which facilitate stock market listings, in particular protections for minority shareholders

in listed companies, have a significant role to play in encouraging a deep and active VC sector (Armour, 2002). A 'flexible' corporate law which is adjustable in the light of the diverse transactional structures characterising VC is also desirable (Nigro and Güzlügöl, 2022). Other legal and institutional factors which are thought to play a role in promoting VC include tax law, in particular by enabling the retention of capital gains from share sales; insolvency or corporate bankruptcy law, to the degree that it protects serial 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 (Cumming and Jahan, 2014; Armour and Cumming, 2016).

From this perspective, there are features of the legal framework in Ukraine which may require particular attention from the point of view of encouraging an indigenous VC sector. As we explore further below (section 3), Ukrainian law does not have an exact equivalent of the limited partnership form which is used in the US and UK to structure VC funds. On the other hand, Ukrainian corporate law is sufficiently flexible to accommodate most aspects of VC investment into innovative startups. A number of recent reforms have been specifically aimed at encouraging VC development, including through the Diia City regime for IT startups, which operates as a legal 'free zone' or enclave which adopts many features of common law legal practice which are thought to have a positive role in promoting VC. Tax and employment laws have also been largely aligned, at least in principle, with the needs of the VC sector, via the Diia City regimes as well as wider changes to legal rules across corporate, insolvency and labour law.

In addition to the substantive content of corporate and other laws, the wider institutional environment is a factor affecting the prospects for Ukraine's VC sector. In so far as VC relies on a combination of legal rules and bespoke contractual and governance structures for its efficient operation, the issue of the overall quality of institutions enters the picture. Trust in government and the legal system, or the absence of it, may be of equal or more importance than the content of rules, charters and contracts. Changes to substantive legal rules be of limited value if there is partial enforcement of contract and property rights and a lack of respect for legality in a given society. Changes to the content of rules may interact dynamically, both negatively and positively, with attitudes towards legality (Grilli et al., 2019). This is an issue which has received relatively little attention so far in the comparative literature on the optimal legal framework for VC, but needs to come to the fore if a complete evaluation of the Ukrainian context is to be made.

With these considerations in mind, our analysis proceeds as follows. Section 2 sets out the background to the study, exploring relevant theoretical framings and explaining our methods, which include doctrinal analysis, statistical benchmarking of laws ('leximetrics'), and interview-based fieldwork. Section 3 takes a closer look at the current legal framework in Ukraine, focusing on corporate, insolvency and employment laws and assessing their substantive content against the generally understood legal template for VC, and then stepping back to look at the state of the wider institutional environment, and benchmarking attitudes towards legality and the rule of law in Ukraine against those prevailing elsewhere. Section 4 reports findings from interviews with VC practitioners (funds, startups and legal advisers) designed to elicit their understanding of how the legal framework for VC works in practice, in Ukraine and beyond, which we carried out over a twelve month period from June 2023. Section 5 provides an assessment of our findings and section 6 concludes.

2. Background to the project: theory, state of the art, methodology

2.1 Theoretical framing

The idea that 'law matters' for financial development has been a mainstay of the law and finance literature since the mid-1990s. The theory underlying this claim, derived from new institutional economics, sees a role for law in mitigating information asymmetries and related transaction costs associated with the financing of firms. From this perspective, laws establishing shareholder and creditor rights can mitigate the risks faced by suppliers of finance, thereby reducing the cost of capital and enhancing financial flows (La Porta et al., 1998).

In an extension of the 'law matters' claim, the 'legal origin' hypothesis maintains that it is not the content of laws alone but also the wider institutional infrastructure that matters. According to this view, the legal systems of common law countries are in general more disposed to encouraging market-led growth than civil law systems. This is the result, it is suggested, of the greater flexibility and malleability of the common law with respect to the structuring of commercial transactions (La Porta et al., 2008).

The theory of 'legal institutionalism' goes somewhat further in identifying a role for law in constituting the conditions in which firms and markets operate (Hodgson, 2016; Deakin et al., 2017). The role of the law is not limited to removing or diminishing transaction costs, but in defining markets, which are not natural institutions, and demarcating their scope. Through legal 'coding', property rights attached to physical assets and organisational entities are ranked in order of priority and degree of enforceability (Pistor, 2019). Law firms and other specialist intermediaries use their expertise to combine and aggregate or, alternatively, to separate and unbundle these rights, so as to support commercial and corporate transactions of varying degrees of complexity. By these means, law as an institution and legal intermediaries as actors assume a central role in shaping innovation systems.

Thus a number of theoretical perspectives on the law-finance relation, while to some degree distinct, converge on the proposition that law matters for VC. Relatedly, they imply that cross-national differences in the legal and transactional framework will have implications for the practice of VC.

2.2 Empirical state of the art: how 'law matters' to VC

Applying the 'law matters' hypothesis to the context of VC, studies have identified the role played by specific contractual and governance mechanisms in addressing issues of information and risk. The practice, originating in the USA, of funds taking an equity interest in the form of convertible preferred stock, has been explained as enabling the separation of cash-flow and control rights in ways that protects the fund on the downside while enabling it to realise investment potential on the upside (Kaplan and Strömberg, 2003). Thus the preferential nature of the shareholding gives the fund priority over the common shareholders in the event of insolvency, while its convertibility enables the fund to exchange its holding for the more liquid common stock in the event of the firm's success.

In addition, funds can exercise close control by taking a certain number of board seats and/or by stipulating for board observer rights. Shareholders' agreements, supplementing the terms of corporate charters (articles of association or bylaws), are used to grant funds veto rights over certain transactions and to prevent the dilution of their holdings.

This emphasis on control is consistent with a 'principal-agent' model of the VC-startup relation, in which the fund acts as 'principal' to control potential moral hazard ('self-dealing' and 'shirking') on the part of the founder-entrepreneur as 'agent' (Pollman, 2023). Relatedly, the principal-agent logic sees the firm using its expertise to overcome the 'lemons' or 'adverse selection' problem which would otherwise arise between informed founders and uninformed ultimate investors. Evidence consistent with this understanding comes from some of the earlier empirical studies of VC, which found that VC board membership was correlated with the need for oversight of higher-risk investments (Lerner, 1995; Gompers, 1995). Later research, however, finds that owners do not always cede a majority of voting shares or board seats to funds, indicating a role for the sharing of risks (Bratton, 2002; Bratton and Wachter, 2013).

It is inherent in the notion of 'contingent control' that the degree of monitoring and oversight will fluctuate over funding life cycle (Pollman, 2019). Close control at the seed or early stage phase, in this understanding, may give way to a looser relationship as the investment matures, with funds accepting dilution as other investors join in the later rounds, and allowing successful founders greater discretion and leeway in determining firm strategy. Convertibility allows funds to shift their interests from control to cash flow, returning control to the founder, at the later stages. From this point of view, it is the malleability of the transactional structure that matters, as much as its particular legal or contractual form at any point of the cycle (Perreira, 2003).

In addition to principal-agent considerations, the legal structuring of VC is affected by the 'power law' dynamic, according to which returns to funds are dominated by the hyper-successful performance of a small number of firms within the wider portfolio (Pollman, 2024). With a successful IPO, the fund can expect to exit by cashing in all or part of its investment, generating a return several times the magnitude of its initial stake.

The role of the IPO in structuring incentives has been the subject of several studies, with different theories being advanced. The need for the fund to recover its investments via a flotation or listing may be only part of the explanation for the centrality of the IPO in the VC model. If returns were all that mattered, a trade sale or share transfer might work just as well. According to some accounts, the IPO route has the additional feature of enabling the founder-entrepreneur to retain a significant role in the management of the firm post-flotation (Black and Gilson, 1998). This has the dual effect of heightening founders' incentives to invest their skills and resources in the firm during the startup phase, while also incentivising founders to stay with the firm. Following a trade sale, which leads to the integration of the startup into a larger corporate structure, founders may choose to move on in preference to taking a junior role in the organisation of the acquirer. This can lead to the loss of critical knowledge on the part of acquiring firm. The practice of founders, in their capacity as CEOs as well co-owners of critical equity stakes, and funds, as shareholders, retaining an interest in a merged firm post-flotation, can be understood as a type of signalling, indicating to investors in public markets that the firm has a sustainable future. However, some of the same effects can be obtained through trade sales, with founders and employees of the startup being offered incentives to stay with the firm post-merger or develop a narrative that will help them in their future career (Broughman and Fried, 2013). Over the course of the last decade trade sales have become a more regular feature of VC practice in the US and have become the norm in Europe (Nigro and Stahl, 2021).

IPO dynamics are not all positive. The pursuit of exponential returns may lead startups to prioritise short-term expansion over sustainability. A number of high-profile scandals associated with high-tech startups, extending to cases of fraud, have put the power-law model into question. These cases suggest that board membership and observer rights can only offer partial solutions to information asymmetries in cases of innovative technologies, and that the promise of exponential returns can induce problematic moral hazard effects (Pollman, 2023).

Opportunism also arises in the context of the large majority of projects which do not get to the IPO stage. Founders may wish to exit before the firm realises its full investment potential. In this situation, funds have been known to use their veto powers to prevent 'beach money exits' which are low-risk for founders but imply a limited return for investors (Wansley, 2019). Conversely, a founder may hold out against liquidation beyond the point when the investment is feasible for the fund. In this situation, funds may induce founders to accept 'acqui-hires' in they and other employees are taken on by the acquiring company. Another form of 'failing with honour' is a 'soft-landing insolvency'. In some US states, an 'ABC' (assignment for the benefit of creditors), in which the company transfers assets to a trustee who organises a controlled liquidation, is one route to achieving this.

On the other hand, VCs may come under pressure to liquidate investments before the point at which the founder is ready. This can happen as funds are reaching the end of their duration. In Europe, a seven year or similar term is normal, and in the US the norm is ten with a one or two year extension. Since firms will join at different points in the life of the fund, they will not all have the same opportunities to develop products or services to their full potential. A growing body of litigation in the US courts has been addressing this type of conflict (Bian et al., 2022).

Conflicts may occur not just between funds and founders, but between funds and other shareholders. These 'horizontal conflicts' (Pollman, 2023) are common where outside investors take up equity stakes in the later rounds of financing. Although the fund may in principle be able to invoke anti-dilution provisions to preserve its position, it may in practice have to accept a loss of a controlling or dominant stake as downstream investments are made. 'Pay to play' provisions, on the other hand, can be used to incentivise existing investors to participate in a new funding round. Examples of these are terms which require the conversion of preferred shares to common stock for shareholders who decline to take part in a new funding round, subordinating their interests to those willing to participate in the call.

As these 'power law dynamics' have become more visible in the practice of VC and in litigation, contractual and governance devices have evolved in the direction of growing complexity. As is occurring more widely in corporate finance (Lalafaryan, 2023), debt and equity are becoming increasingly interchangeable, and the boundary between them more fluid. This has led some observers to argue that the role of the VC fund is changing, from that of monitoring and overseeing firms' development, to dynamic management of risk across the different relationships, both vertical and horizontal, which make up the VC 'architecture' (Brougham and Wansley, 2023).

Relatedly, there is a growing focus on ways in which formal and informal norms interact in structuring VC (Grilli et al., 2019). Here, the concept of 'braiding' is invoked to explain how formal mechanisms depend on informal elements, in the form of reputation and trust which are built up through repeat trading, for their operation (Nigro and Stahl, 2021). This perspective also emphasises the need to see VC governance structures as part of a wider 'ecosystem', in which information sharing and knowledge spillovers generate wider gains for sectors and regions with a significant VC presence (Saxenian, 1994; Aoki, 2010).

In this context, the literature on 'associational cognition' sees VC as a 'virtual corporate architecture' through knowledge is generated and diffused across a cluster of firms and related institutions. In this wider ecosystem, collaborative networks between startups and a range of public and private institutions including universities, hospitals and research organisations, can be observed (Aoki, 2010). Career mobility between startups and universities assists a two-way flow of knowledge (Owen Smith and Powell, 2004). In this understanding, VC funds become 'information brokers', leveraging the knowledge and expertise they obtain as monitors for the wider benefit of a series of actors. While certain cognitive assets are tied up within individual firms and protected through IP law and rules of commercial confidentiality, there is a wider sharing of more generic information on how manage innovation risks and address uncertainty, across the wider network. The two types of knowledge, firm-specific and sector-generic, can play complementary roles in supporting the 'ecosystem' (Saxenian, 1994).

While the malleability of corporate and commercial contract law is thought to be essential in enabling the 'architecture' of VC-firm relations, the wider benefits of the innovation ecosystem may depend on the flexibility provided by other areas of law. Employment law plays a role, depending on how strictly it regulates hiring and dismissal decisions; ease of hire and fire on the part of firms is generally thought to mitigate investment risks (Armour, 2002). At ecosystem level, on the other hand, knowledge spillovers may also depend on the ability of employees to move between firms at short notice, without the restraints imposed by non-compete clauses. There is uncertainty over how far California's near-complete ban on non-competes in employment contracts might have stimulated the 'high velocity labour market' of Silicon Valley, but there is little doubt that California's liberal position on employment restrictions is a point of difference with other high-tech clusters, elsewhere in the US and in other countries, which have not experienced the same success in generating spillovers from VC (Hyde, 2011). A lenient bankruptcy law, which avoids unduly penalising entrepreneurial failure, is another factor often cited to explain Silicon Valley's success (Armour, 2002).

The tax treatment of investments and receipts is also understood to have been a significant factor behind the expansion of VC in its US base as well as in the UK (Grilli et al., 2003). Allowing tax relief on the investments made by the limited partners in VC funds is one such instance, as are the rules which minimise the taxation of capital gains on grants of shares and share options to startup founders and employees. It has been suggested that the tax treatment of preferred stock is just as good an explanation for its prevalence in US VC practice as its supposed properties as a governance device (Gilson and Schizer, 2002).

VC began as a US-based phenomenon and the institutional architecture which underpins it, from corporate charters and the standardised terms produced by industry-level associations is also predominantly American in origin. The idea that 'law matters' for VC has accordingly prompted an extensive literature exploring how far laws and practices in other countries differ from the original US model, and assessing the consequences of this divergence, which are generally understood to be negative for VC development (Armour and Cumming, 2006).

The UK, which has had a significant VC sector since the 1980s although a significantly smaller one than in the US, has some features of its legal framework which are similar to the US, and some significant differences (Armour, 2002). It has a malleable common law foundation to its commercial and corporate laws, and is also similar to the US in providing extensive protections for minority shareholders in public companies, of the kind believed to be important for encouraging IPOs. The UK's personal bankruptcy law has become more lenient over time, in part in response to pressures to emulate the US approach in this respect. Not everything in the UK mirrors US practice, however. UK dismissal law is less pro-employer than that in the US, where the contract at will rule mostly prevails, but is still less protective than the OECD average. In a marked contrast to California, English courts

regularly enforce employment non-competes in the form of restrictive covenants and garden leave clauses. The enforcement of non-competes in the UK does not appear to have had an inhibitory effect on its VC sector, although it is possible that it has limited the scope for employee mobility, and the resulting knowledge spillovers, which are characteristic of Silicon Valley.

There is a complex picture when it comes to assessing the degree to which mainland European jurisdictions provide a supportive framework for VC (Martin et al., 2002; Armour, 2002; Lerner and Schoar, 2005; Kaplan et al., 2007; Armour and Cumming, 2006; Bonini and Alkan, 2012; Cumming et al., 2016; Perreira, 2023; Giudici et al., 2023; Enriques and Nigro, 2024). Certain features of the US VC model can, it seems, only be made to work with some difficulty in civil law systems. The practice of funds taking convertible preferred stock is rarely observed outside the US, perhaps because of the absence of the beneficial tax treatment which has been argued to underpin its use there, but also because some company law systems do not recognise or otherwise facilitate the conversion of preferred to common stock. Shareholders' agreements providing for veto rights and liquidation preferences may come into conflict with background rules of corporate law which are treated as non-waivable or at least as 'strong defaults' in civil law doctrine (Perreira, 2023).

On the other hand, there is evidence to suggest that the absence of convertibility is not a fundamental barrier to the adoption of VC-style governance in mainland European countries. In Italy, non-convertible participating preferred shares are used to give VC funds priority over other investors, and mechanisms for converting debt to equity, similar to SAFE ('simple agreement for future equity') and KISS ('keep it simple security') notes of the kind found in US VC, are available. Co-sale mechanisms can also be observed. US-style 'drag along' rights, which enable majority shareholders to require minorities to join in a sale or call, and 'tag along' provisions, through which minority shareholders can enforce their participation against the wishes of the majority, can also be found in European practice. In the light of this evolution it has been argued that 'corporate practice is pushing the envelope', with the general law, through reforms to legislation governing private companies and other LLC equivalents, and modifications to corporate charters and contract terms, responding to the pressures for change in countries such as Italy (Giudici et al., 2023). An alternative view is that Italian corporate law is still 'unable to accommodate (US-style) VC contracting', and that 'bargaining in the shadow of the law and implicit mandatory provisions of Italian corporate law leads to the adoption of a contractual technology that is overall costlier and less effective than the US model' (Enriques and Nigro, 2024).

Similar assessments have been made of the situation in China. Chinese VC uses a functional equivalent to convertible stock in the form of the VAM ('valuation adjustment mechanism'), a contractual device which allows the VC fund to adjust the valuation of a portfolio company on the occurrence of a stipulated future events (Lin, 2020; Giudici et al., 2023). However, significant barriers to the transplantation of US standards terms and practices into the Chinese context have been identified, including a 'lack of serious investment tools and the legal restrictions in the Company Law, the lack of effective protection of investors by law, and the presence of less experienced and sophisticated venture capitalists and entrepreneurs in China' (Lin, 2020: 42).

In addition to substantive legal rules and contractual practices, trust in the host country's legal institutions and market practices has been identified as a factor mediating cross-border VC. Unsurprisingly, foreign VC inflows are negatively affected by perceptions of a high level of corruption and lack of respect for legality in emerging markets (Botazzi et al., 2016). In countries characterised by collectivist values and a social norm of 'uncertainty avoidance', VC practice is less responsive to the legal-regulatory framework, suggesting that there is a limit to how far changes to the formal law can be used to encourage VC without wider institutional and cultural changes (Li and Zahra, 2012).

Even in developed countries with stable legal systems and the appearance of respect for the rule law, VC reputation and other aspects of 'relational trust', indicating a belief in the trustworthiness and reliability of key actors in a VC ecosystem, affect investment levels (Hain et al., 2016). Networks linking funds and startups to public institutions, including universities and hospitals as well as funding bodies and regional development agencies, are reported to be helpful 'for building relations' so that 'a better environment is established before venture capitalists invest their funds' (Grilli et al., 2019: 1110). Public interventions to build trust in the ecosystem as a whole may be a more viable strategy than direct government funding of VC, which appears to have a mixed record at least at the level of generating financial returns (on this see the contrasting analyses of Da Rin et al., 2006, and Cumming, 2011). There is evidence for the positive effects of targeted public procurement progammes (Connell, 2017).

Countries with emerging VC sectors can seek to take advantage of more amenable environments overseas by taking advantage of the rules of private international law which allow firms to designate foreign legal system as the applicable for corporate structures and related commercial transactions. Since the 1990s, the Israeli VC sector has operated this way, with significant numbers of startups incorporating in Delaware law and listing on NASDAQ (Clarysse et al., 2009). An entity physically based in one jurisdiction, the 'home' state or state of origin, can incorporate and list in another, which becomes then its corporate law 'host', while remaining subject to tax and employment laws in the former. The costs and benefits of this route, and its extent beyond the well known Israeli case, have been relatively little studied. The practice may be helpful in providing reassurance to overseas investors and in enabling the firm to take advantage of legal and professional expertise in the host jurisdiction, but may end up sacrificing some of the wider networking effects and ecosystem benefits of VC.

2.3 Research methods

Most studies assessing the role of the legal framework with respect to VC have taken a quantitative approach, using surveys and publicly available datasets to track the use of particular terms and devices in corporate charters and agreements, and building indices to benchmark developments in the formal content or substance of legal rules. Relatively few analyses have used qualitative approaches, which has resulted in something of a gap in the literature. There is a disconnect between the understanding that informal norms structure or pattern the operation of formal ones, and that the interaction or 'braiding' of the formal and the informal is often key to understanding the way that innovation systems work in practice, and the lack of qualitative evidence of the kind needed to assess the role of informal factors (Grilli et al., 2019: 1115).

In principle, a 'mixed methods' approach, combining quantitative and qualitative approaches, is to be preferred to one relying solely on a single technique. Quantitative studies tend to be thought of as the gold standard in law and finance research, since they possess features of objectivity and replicability which are consistent with general understandings of the need for external validity in social science research. However, surveys or reviews of the texts of corporate charters and contracts are rarely able to establish that they are representative of wider practice, much of which remains hidden from view, and they can quickly become dated, given how quickly VC evolves. Regression analyses can establish statistical associations between the terms of charters and contracts, on the one hand, and quantifiable variables such as magnitudes of investments flows and returns, on the other, but establishing a reliable causal connection can be more difficult, given that causal relations could, in principle, flow either way; laws and practices might well be responses to investment flows, for example, rather than an exogenous cause of them (Grilli et al., 2019: 1110).

Qualitative methods also have some well known drawbacks. Representativeness is even more of an obstacle here, and replicability is an issue given the temporal and spatial specificity of individual interview settings. On the other hand, interviews can enable researchers to identify the causal mechanisms and sequencings which are mostly invisible to more quantitative approaches (Poteete et al., 2009).

A mixed methods approach may be especially helpful for understanding how the 'braiding' of formal and informal elements of VC architecture. The 'braiding' hypothesis was first developed in the study of research and development agreements and similar contracts involving innovation (Gilson et al., 2009, 2020, 2011; Jennejohn, 2008). While knowledge sharing and information diffusion are understood to be an essential aspect of innovation systems, the risk of opportunism grows the longer a relationship continues and according to the number of actors involved. Formal contract terms may be one way of reducing the risk of opportunism, but parties seeking to rely on them may face high enforcement costs (Perreira, 2023). Reputation, on the other hand, may be an effective way of constraining moral hazard, particularly in contexts of repeat trading, or in the context of an innovation ecosystem where behaviours can be publicly observed (Aoki, 2010: 100). Extending the 'braiding' concept to the context of VC, what needs to be understood is how the complex 'palette' of charter terms and contractual devices (Giuidici et al., 2023: 791) interacts with the parties' strategies and behaviour to shape outcomes. Interview-based research, allowing a 'deep dive' into the lived experiences of participants, may provide access to information which would otherwise remain hidden from view or least inaccessible beyond the sector itself.

With these points in mind, we have constructed our empirical project using a multi-methods approach, as follows.

The first part of our analysis focuses on formal laws and related mechanisms of regulation (section 3). We conduct a legal review of provisions of Ukrainian law which have a direct bearing on the VC environment, including relevant elements of corporate, insolvency, employment and tax law (section 3.1). In order to facilitate the benchmarking of Ukrainian laws against those of other systems, we use the indices of company, insolvency and labour law developed in the framework of the Cambridge Leximetric Database (section 3.2). The methodology of the Cambridge database involves the manual coding of legal provisions of different countries using a common protocol which facilitates comparisons between them. This gives us an approximate measure of how far Ukrainian laws supports shareholder, creditor and employee rights of the kind which are likely to influence the VC investments and transactional structures. We then consider a number of additional indices which provide measures of the wider institutional environment in Ukraine. These are indices which offer an assessment of the state of the rule of law and respect for legality across countries, namely the V-Dem Rule of Law Index, the WJP Rule of Law Index, and the Heritage Foundation Rule of Law Index. These provide us with an additional source of statistical information for the purpose of benchmarking Ukraine's current situation.

We then report the findings our qualitative study (section 4). This is based on 25 interviews conducted with VC specialists in funds, startups, law firms and industry associations between June 2023 and June 2024. The interviewees were initially identified through industry associations and public sources, with further contacts being established through the snowballing method. The focus of the interviews was on the experience of Ukrainian VC funds and startups in using contractual and governance mechanisms to structure their relations and on their perceptions of the wider legal and institutional framework. The interviews also ranged more widely to cover the current state of VC practice in the UK and other European countries. The interviews were not recorded, for confidentiality reasons, but were transcribed in writing during the interview process and finalised after the interview. The texts

of the interviews were analysed using a manual coding scheme through which key themes were identified.

3. The legal environment for VC in Ukraine: a closer look

3.1 Substantive legal rules affecting VC

The Ukrainian civil code lacks an exact equivalent to the limited partnership form which VC funds generally use to structure their own activities. An overseas investor can enter into a joint venture with a Ukrainian partner through a 'joint activity agreement', but there are complexities associated with the process through which such joint ventures are registered with the Ukrainian tax authorities. Additional issues arise from the rigid legal form of the 'joint activity agreement': participation rights cannot circulate freely, as any change to membership creates legal complexities, and it is difficult to organise management, as there is no established template for board membership or the operation of the board's powers of oversight and control.

Under Ukrainian law, a distinct tax regime applies to VC funds which are locally registered. No income tax is charged on capital gains during the life of the investment. VC funds can lend to their own companies and thereby reduce their income tax liabilities. This has led to the use of VC fund structures to minimise tax liabilities in contexts where no innovative activity is being undertaken, for example in the real estate sector. VC funds have also been used to disguise the ultimate ownership of corporate conglomerates.

The general tax regime provides few benefits to small and medium sized firms engaging in innovation. There is a risk that income tax will be charged on shares and share options allotted to founders and employees, in circumstances where valuations may turn out to be short lived. However, companies incorporating the Diia City 'free zone' benefit from an advantageous tax regime, under which capital gains to employees are either not taxed at all or at a low rate depending on circumstances. Tax on income from employment is charged at 5%, and social security contributions are set at 22% of the minimum wage. Corporation tax is charged at a low 18% and at 9% when exiting an investment. No tax at all is charged on dividends provided that they are paid no more than once in every two years. The Diia regime also provides a tax rebate on investments in Ukrainian-based startups: personal income tax is paid only on net gains.

When it comes to the operation of general corporate law and its implications for the ways VC funds structure their investments with startups, Ukrainian law is, in principle, sufficiently flexible to accommodate most VC practices. The laws governing smaller companies (LLCs) and joint stock companies (JSCs) do not stand in the way of serial investments by funds. The law permits the inclusion of pre-emption rights in articles of association. Other terms which are commonly used to protect VC funds, including liquidation preferences and dividend priority rules, are possible under Ukrainian law, although there is some uncertainty over how far they will work in practice.

The Diia City law creates a template including several features which are typical of VC elsewhere, including non-disclosure agreements, non-competes, convertible loan notes, option agreements, and representations and warranties. While the Diia City regime makes provision for convertible loan agreements under which the fund has the right to require a debt-equity swap at a certain point,

provisions of general company law may stand in the way of this being enforceable. While the fund can demand repayment of the loan, it may be more difficult to require the startup company to grant it an equity stake, as a decision to increase its equity capital depends on the agreement of the shareholders as a whole.

With respect to board structure, Ukrainian law has recently (since 2021) become more closely aligned with practice elsewhere in Europe by allowing joint stock companies the option of adopting a single, unitary board, as opposed to the two-tier structure, with separate executive and supervisory boards, which was previously mandatory. The two-tier structure remains an option which may be useful for strengthening the role of independent directors in the later stages of VC financing.

As of 2021, Ukrainian law allows a foreign law to be chosen for a shareholders' agreement, if at least one of the parties is non-resident. However, this route is of limited practical value for domestic Ukrainian VC funds and startups. If both parties are Ukrainian legal entities, an agreement to use foreign law will be void. If Ukrainian law is used, it may not be possible to give effect to an agreement which contradicts the provisions of company's articles of association or the general corporate law. For example, the corporate law recognises the principle of 'free exit' from the company through a share sale, which may come into conflict with clauses in an agreement designed to prevent the founder cashing out their stake prematurely, which are a common feature of VC funding arrangements in other countries.

3.2 Benchmarking Ukraine's corporate, insolvency and employment laws

As we have seen, the law and finance literature argues that legal systems which are broadly pro-shareholder and pro-creditor in their operation can thereby help to increase the supply of capital and reduce its costs, so favouring VC in broad terms. Conversely, according to this point of view, the more flexible a country's employment laws, the more favourable the context for the development of VC (Armour, 2002; Armour and Cumming, 2006). To obtain an estimate of the degree to which Ukraine's general laws governing enterprise support VC in this sense, we apply the coding protocols developed by the Cambridge Leximetric database (Deakin et al., 2023) to Ukraine's recent legal development.

The results are shown in Figures 1 to 3. These indicate, firstly, a rising trend in shareholder protection. This is associated, among other things, with the changes to the joint stock company law in 2021.

The creditor protection index for Ukraine also shows an increase. In October 2019, a new Code of Bankruptcy Proceedings took effect, replacing bankruptcy law that had been in force since 1992. The new law strengthened creditors' rights by allowing them to select their bankruptcy administrator, decide the starting prices of debtor assets at auction, and participate in other asset sales matters. The law also improved the procedures for selling debtors' assets by introducing online auctions and removed a requirement for asset collection through courts or enforcement services before insolvency proceedings can begin, easing the debt collection process and reducing legal costs for creditors. The new bankruptcy code also provides additional protection of secured creditors.

With respect to labour laws, on the other hand, there has been a significant decrease in worker protection with effect from 2022. These changes modify the dismissal regime in the direction of greater employer flexibility to terminate and establish a relatively light-touch labour law regime for smaller and medium sized enterprises, defined as those employing fewer than 250 workers. These changes were made under emergency powers and justified by the needs of the wartime economy, but were planned before the outbreak of the current conflict with Russia in February 2022.

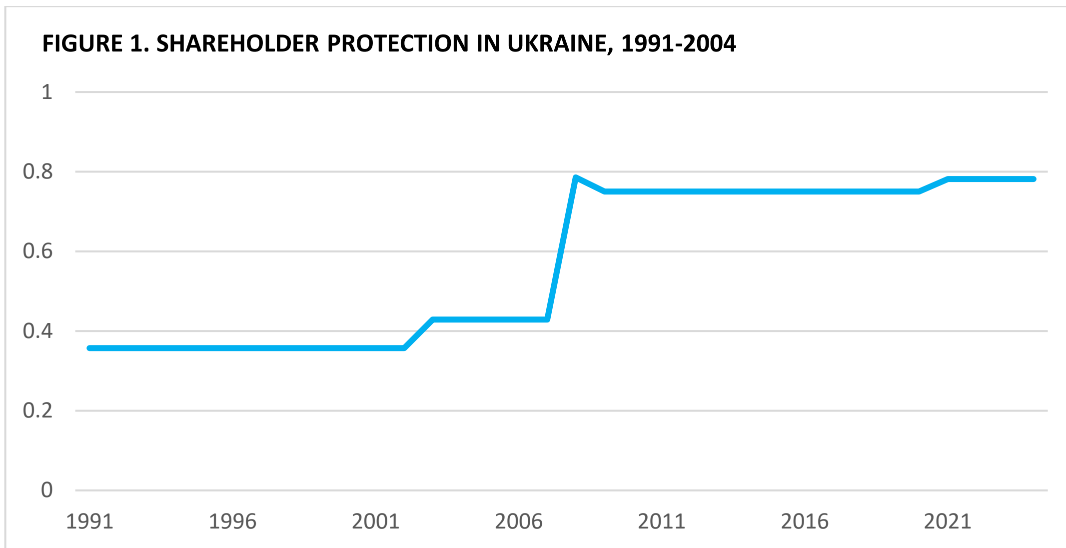


Figure 1. Shareholder protection in Ukraine. Source: Cambridge Leximetric Database (Deakin et al., 2023). Note: a higher score on the vertical axis indicates an increased degree of shareholder protection through formal law. For further details on methodology, see Deakin et al., 2023.

Figure 2. Creditor protection in Ukraine. Source: Cambridge Leximetric Database (Deakin et al., 2023). Note: a higher score on the vertical axis indicates an increased degree of creditor protection through formal law. For further details on methodology, see Deakin et al., 2023.

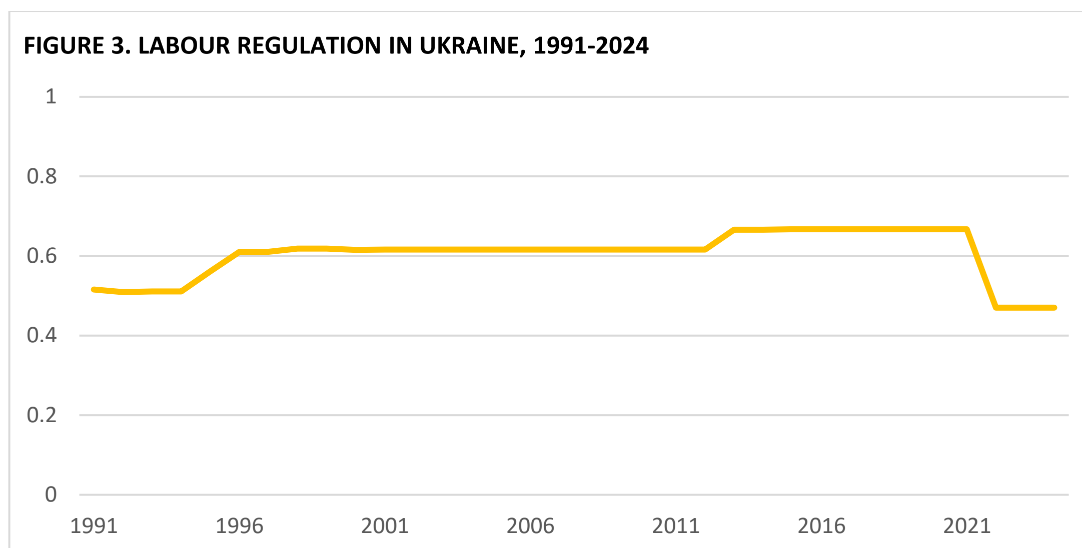


Figure 3. Labour regulation in Ukraine. Source: Cambridge Leximetric Database (Deakin et al., 2023). Note: a higher score on the vertical axis indicates an increased degree of worker protection through formal law. For further details on methodology, see Deakin et al., 2023.

3.3 Benchmarking the rule of law in Ukraine

As mentioned above, VC relies on a combination of legal rules and bespoke contractual and governance structures for its efficient operation. Changes to substantive legal rules may be of limited value if there is partial enforcement of contract and property rights and a lack respect for legality in a given society. In essence, legal rules must be delivered by a *competent* and *credible* state. Therefore, countries must provide the appropriate legal framework and ensure that governments demonstrate an overarching respect for the institutions governing economic and social interactions. The extent to which a country displays a credible commitment to the impartial administration of legal rules is demonstrated by the presence of a number of factors which support the core economic institutions of a market economy, particularly those that rely on third party enforcement (for example, private property rights and contract enforcement). These factors include the rule of law (Barro, 1996; Bhagat and Wittry, 2020; Dollar and Kraay, 2003; Keefer and Knack, 1997; Rodrik et al., 2004), predictability in judicial decision making (Brunetti et al., 1998), absence of corruption d Delavallade, 2011; Edgardo Campos et al., 1999; Hongdao et al., 2018; Mauro, 1995), greater judicial independence (La Porta et al., 2004), lower crime rates (Barro, 1996), political instability (Alesina et al., 1996), and the security of property rights and the quality of contractual enforcement (Claessens and Laeven, 2003). Each of these governance factors have been found to positively impact growth outcomes and are typically captured – to some extent or another – by rule of law indices. While there is significant debate surrounding the direction of causality between institutional reforms and economic growth (Hammergren, 2008; Messick, 1999), the use of indicators to measure institutional quality (Botero et al., 2016; Botero & Ponce, 2011; Davis, 2004; Ginsburg, 2011; Gisselquist, 2012; Møller & Skaaning, 2011), and the means to improve institutional quality (Abrahamsen, 2012; Carothers, 2006; Gisselquist, 2012), there is a predominant sense that institutions matters for growth.

To obtain an estimate of the degree to which Ukraine's institutional environment supports VC, we have disaggregated data on the rule of law from indexes development by the World Justice Project ('WJP') and Varieties of Democracy ('V-Dem'). The V-Dem Rule of Law Index attempts to capture the extent to which laws are transparently, independently, predictably, impartially, and equally enforced,

and the extent to which government officials comply with the law. The V-Dem dataset is comprised of subjective data gathered from country experts. The V-Dem Rule of Law Index is comprised of 15 factors: access to justice for men, access to justice for women, compliance with the high court, compliance with the judiciary, executive bribery and corrupt exchanges, executive embezzlement and theft, executive respect for the constitution, high court independence, judicial accountability, transparency of laws with predictable enforcement, rigorous and impartial public administration, public sector theft, public sector corrupt exchanges, lower court independence, and judicial corruption. Unlike the WJP, V-Dem solely relies on expert judgment.

The WJP index is designed to capture the "experiences and perceptions of ordinary citizens and in-country professionals concerning the performance of the state and its agents and the actual operation of the legal framework in their country". The WJP Rule of Law Index provides data from 2015 to 2023, and ranks countries based on eight factors and forty-four subfactors (see Appendix 1); data is drawn from assessments of a General Population Poll and a series of Qualified Respondents' Questionnaires. The WJP defines the rule of law broadly as compliance with the WJP's four universal principles: accountability, just law, open government, accessible and impartial justice. As such, the WJP Rule of Law Index is more extensive than the V-Dem Index and includes substantive factors that capture, to varying extents, the content of legal rules alongside the enforcement of legal rules and individual's experience of the legal system.

As will be discussed later in section 4.9, interview respondents frequently identified the quality of legal rules as a determinant factor for VC investors. Equally, the quality of institutions was a recurring theme, in particular, there was a widespread acknowledgement that the persistence of corruption was a barrier to the movement of capital into Ukraine and a major factor in the use of foreign legal structures to provide reassurance to investors. However, in response to insufficient judicial independence, low public trust in the judiciary, and high levels of corruption, Ukraine has reformed key judicial governance bodies in line with the Venice Commission recommendations (European Commission 2023, p. 20). Additionally, Ukraine has introduced a number of measures to tackle corruption including the establishment of a separate legal entity for the Specialised Anti-Corruption Prosecutor's Office (SAPO) (Transparency International, 2024). Since the reforms were introduced in 2021, public trust in the judiciary has risen from 15.5% to 24.8%. Transparency International Ukraine also found an overall improvement in anti-corruption bodies from 3.4 to 3.9 on a scale of 1 to 5.

However, Transparency International also noted ongoing issues, including the lack of an independent body responsible for conducting forensic analysis in high-level corruption cases, and the lack of powers for SAPO to prosecute members of parliament (Transparency International, 2024). Likewise, the OECD's most recent review of Ukraine's Anti-Corruption reforms found that, while anti-corruption policy was developed through an evidence-based, inclusive and transparent approach, there remains a persistent issue with enforcement of corruption offences (OECD 2024). Further, the European Commission notes that "foreign business associations continue to cite problems with the judiciary and the prevalence of corruption as some of the main obstacles to doing business in Ukraine" (European Commission 2023, p. 21).

As corruption remains a persistent issue, for the purposes of this study, we focus predominantly on variables relating to corruption and enforcement; issues that appear to be of particular concern for attracting VC to Ukraine. We further compare Ukraine's institutional environment with Estonia, Hungary, Poland and Georgia. The results are shown in Figures 4 – 11. We find that the perceptions of interview respondents are reflected in the rule of law indices, reinforcing the finding that weak institutions, particularly those relating to control on corruption, may be negatively affecting Ukraine's capacity to attract VC.

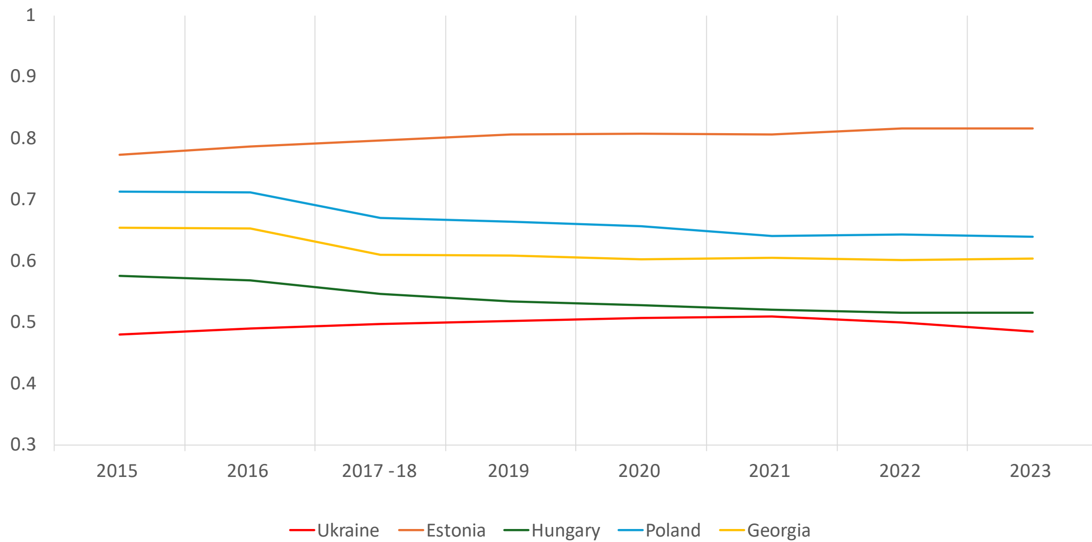


Figure 4. WJP overall comparison between Ukraine and other countries. Source: World Justice Project.

Overall, Ukraine is lagging behind its counterparts (Figure 4). Throughout the period 2015-2023, Ukraine has performed below all comparator countries, sitting closer to Hungary than Estonia (the highest performer of the comparators). If we breakdown the overall ranking into the eight main factors captured by the WJP rule of law index (Figure 5), Ukraine performs best on Order and Security (factor 5) with a score of 0.75 in 2021 and worst on absence of corruption (factor 2) with a score of 0.32 in 2021. This may indicate that conflict is effectively limited among the general population, however, the effective enforcement of law may not extend to government officials.

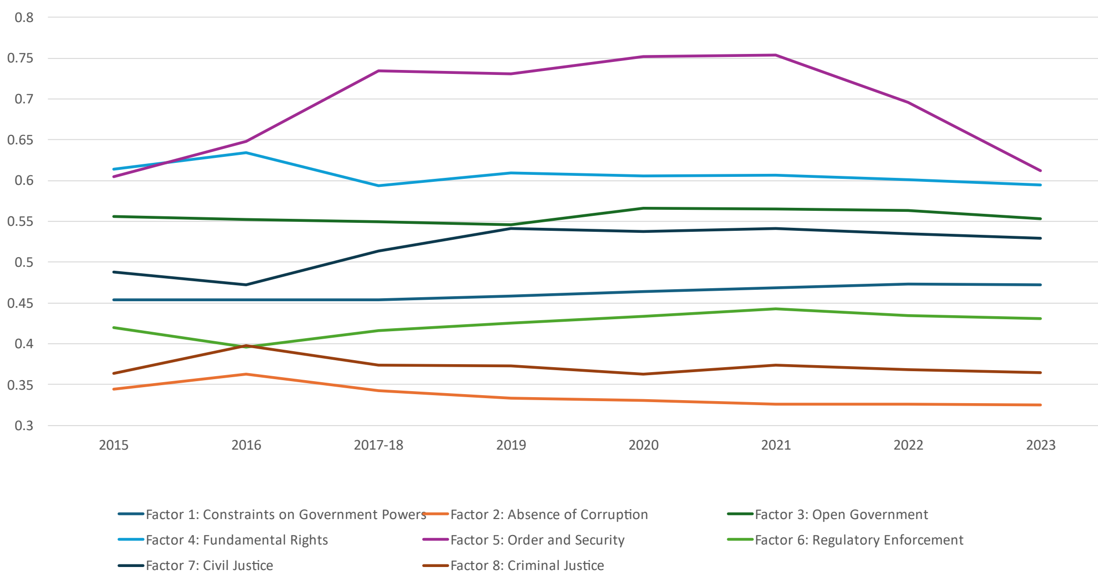


Figure 5. WJP Rule of Law Index: Ukraine overview. Source: World Justice Project.

Factor 5 captures the extent to which crime is effectively controlled, and civil conflict and violence is limited. Order and Security variables are often used “as proxies for the security of property and contract rights”(Keefer & Knack, 1995, p. 5). However, they may be closer to a measure of the state’s coercive power (Humphreys, 2010) as they tend to capture crime rates rather than measure corruption or the accountability of government (Davis, 2004, p. 149). The inclusion of such variables in a Rule of Law Index may, therefore, have a distorting effect. Indeed, we see the extent to which factor 5 inflates Ukraine’s rule of law ranking in Figure 6. While Estonia suffers a marginal reduction in its overall rule of law score when “order and security” is removed from the equation, Ukraine observes a marked decline (albeit improving in 2023). Consequently, we should be cautious when relying on order and security variables as a proxy for the type of enforcement that matters to VC. Order and security variables appear to indicate a “top-down” enforcement of law rather than an equal horizontal and vertical respect for law.

FIGURE 6. IMPACT OF FACTOR 5 ON WJP RANKINGS

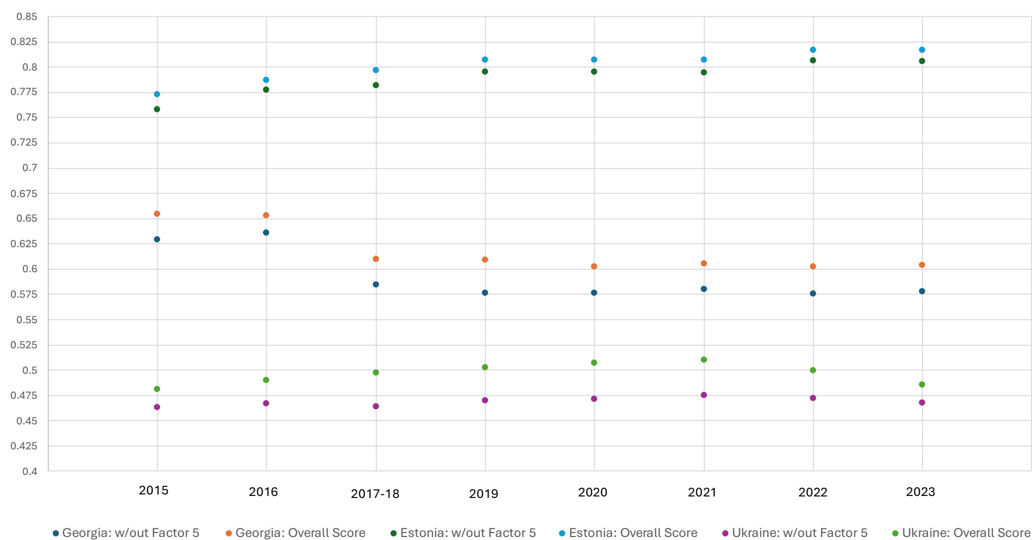


Figure 6. Impact of factor 5 on WJP rankings for Ukraine. Source: World Justice Project.

Rather, factors 1, 2, 6 and 7 may be more indicative of the quality of governance that matters for VC. Returning to Figure 4, Ukraine performs weakest on markers of corruption, accountability, regulatory enforcement, and civil and criminal justice. However, there has been an improvement over time in the quality of civil justice. When we disaggregate this variable (Figure 7) we see that alternative dispute resolution mechanisms play a significant role in the effective enforcement of civil justice and appear to be considered significantly more accessible, impartial and effective than the judicial system. Factors 7.3 and 7.4, capture, respectively, the extent to which civil justice is free of improper government influence and corruption. These appear to be particular areas of weakness in Ukraine’s civil justice system.

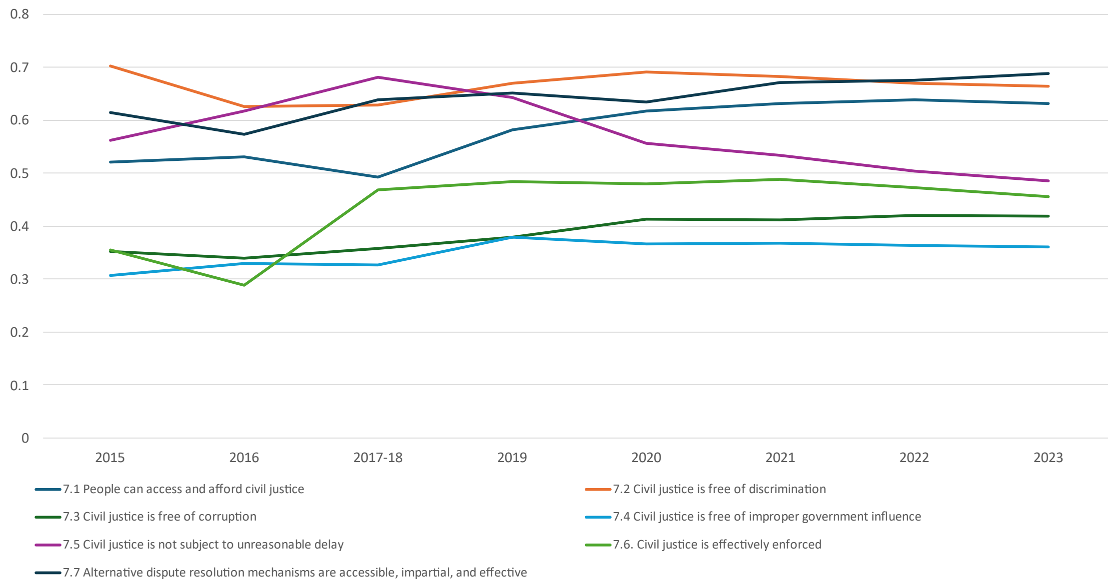


Figure 7. Civil Justice in Ukraine. Source: World Justice Project.

Figure 8 compares the strengths and weaknesses in the civil justice system in Ukraine and our comparators. This figure illustrates that many post-Soviet nations are pulling towards alternative dispute resolution mechanisms due to issues of delay, improper government influence, and corruption. While Estonia displays a more uniform commitment to the seven aspects of the civil justice system captured by Factor 7, that consistency across civil justice falls away when we look to Ukraine, Hungary, and Bosnia and Herzegovina. Therefore, we would expect that corruption, and the timely delivery of civil justice may be acting as barriers to attracting VC.

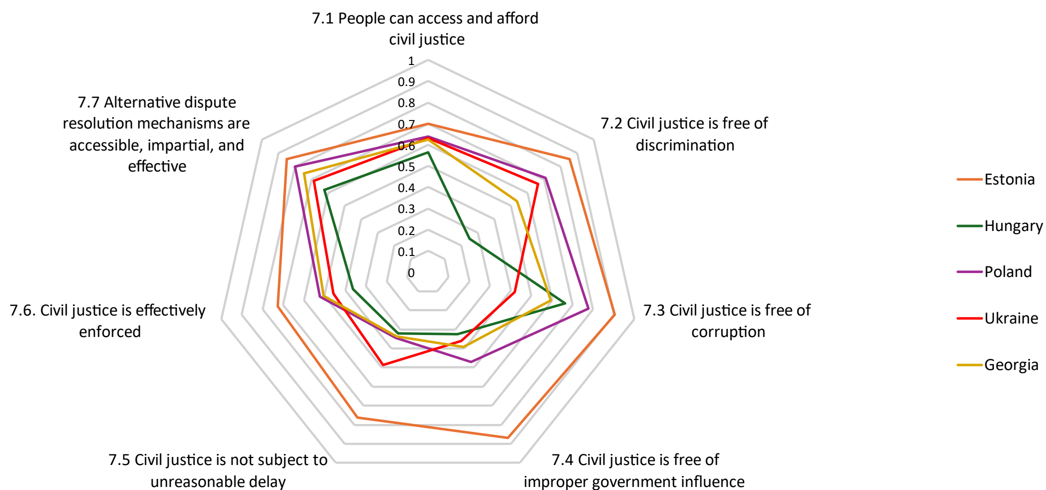


Figure 8. Civil justice in 2023 in Ukraine and other countries. Source: World Justice Project.

Focusing in on the issue of corruption more precisely, Figure 9 disaggregates Factors 1 and 2 on constraints on government power and absence of corruption, respectively. In relation to constraints on government power, there appears to be a perception that the judiciary does not act as an effective constraint on government power, and that government officials are not sanctioned for misconduct (factor 1.4). With a score of 0.29 on factor 1.4 in 2023, Ukraine ranks below Afghanistan and far below the regional (0.37) and global averages (0.47). While we might expect to see this reflected in factor 2.2 on corruption in the judicial branch, the primary locus of corruption appears to be in the legislative branch (factor 2.4). On factor 2.4 Ukraine has a remarkably law score of 0.7 in 2023 placing it just above Haiti, on a par with Guatemala, and below El Salvador and the Democratic Republic of the Congo. While corruption in the judiciary appears to be lessening over time, corruption in the executive and legislature appears to be increasing. This may be because the judiciary does not effectively limit the exercise of government power. For instance, Transparency International lamented a 2020 decision of the Constitutional Court which resulted in it no longer being illegal for public officials to lie in their declarations of financial interest and assets (Borovyk, 2020).

FIGURE 9. WJP UKRAINE: FACTORS 1 & 2

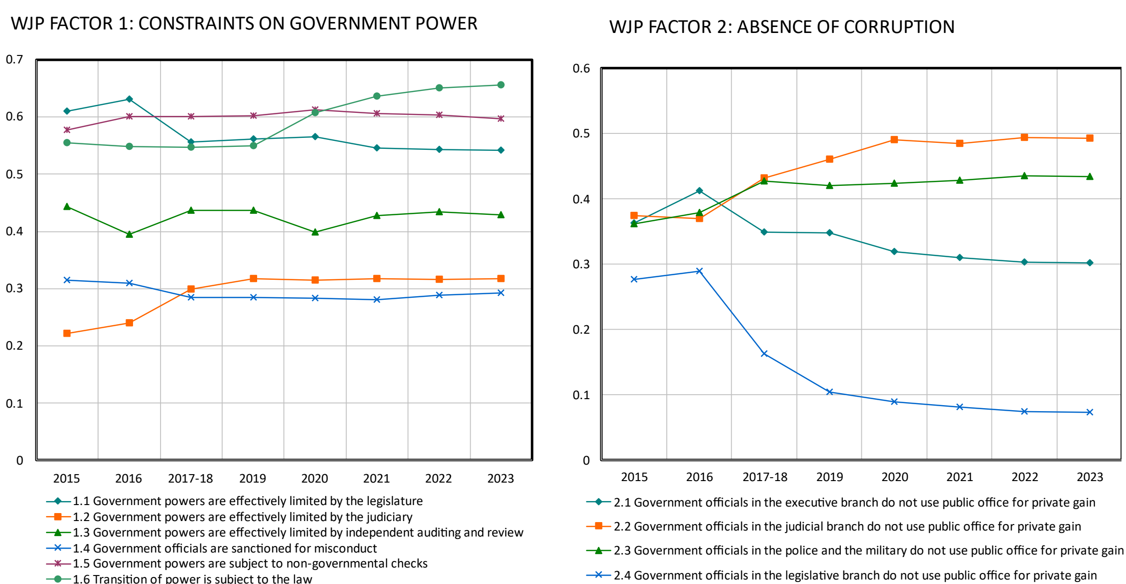


Figure 9. WJP Ukraine: factors 1 and 2. Source: World Justice Project.

The sudden decline in trust in the judiciary in 2020 appears to be captured by Figure 10 which disaggregates selected variables of the V-Dem Rule of Law Index. Interestingly, the V-Dem Rule of Law Index, which is based on data collected from experts, captures greater corruption in the judicial rather than executive branches (and does not have a specific metric for the legislative branch). The "judicial corrupt decision" variable measures the frequency of individuals or businesses making undocumented payments or bribes in order to influence judicial decision making; a score of 4 represents the absence of corruption. In 2022, Ukraine received a score of 1.56 for judicial corrupt decision and score of 1.7 and 2.71 for executive embezzlement and theft, and executive bribery and corrupt exchanges, respectively. For public sector corruption and theft Ukraine scored 1.88 and 2.36, respectively.

FIGURE 10. SELECT V-DEM VARIABLES

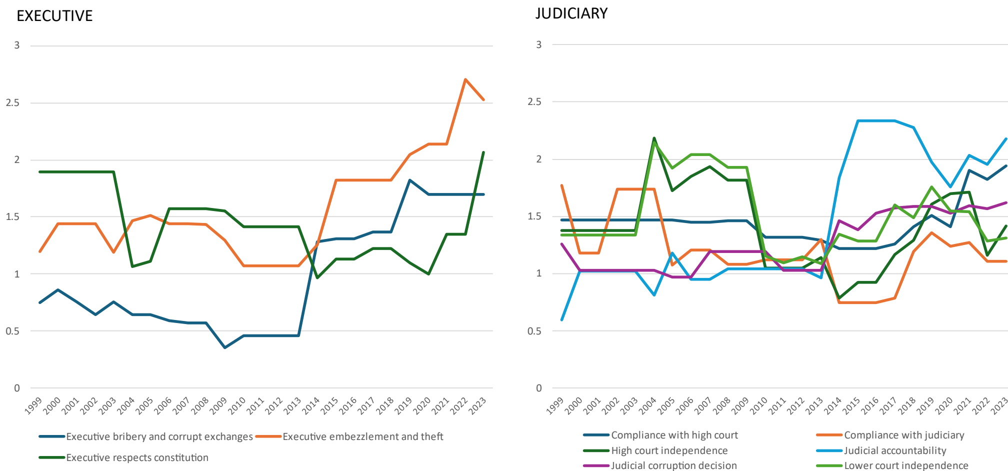


Figure 10. Select V-Dem variables for Ukraine. Source: Varieties of Democracy.

While there have been improvements overtime, and particularly since 2014, Ukraine still ranks concerningly low among its counterparts. For instance, Ukraine has not seen significant gains such as those experienced by Georgia following the Rose Revolution in 2003.

FIGURE 11. V-DEM RULE OF LAW INDEX COMPARISON

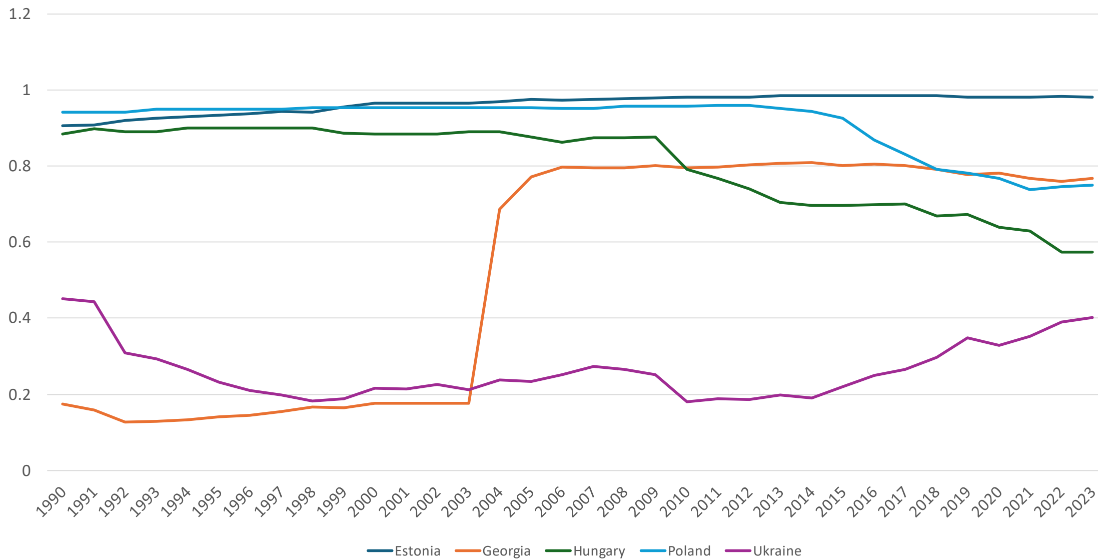


Figure 11. V-Dem Rule of Law Index comparison between Ukraine and other countries. Source: Varieties of Democracy.

Overall, corruption appears to be a persistent problem in Ukraine, alongside inefficiencies in civil justice. This may lead to an over-reliance on alternative forms of dispute resolution and is likely motivating VC funds to opt for foreign law or foreign courts. Concerningly, Ukraine's institutional environment appears quite stagnant (Figure 11). Since 1990, Ukraine has failed to make significant gains in institutional quality, with those gains made in the last ten years still leaving Ukraine below its

highest score of 0.45 in 1990 on the V-Dem Rule of Law Index for the period 1990-2023. While Ukraine is on an upward trajectory unlike some of its other post-Soviet counterparts (e.g., Hungary and Poland), it stills lags significantly behind in terms of overall institutional quality.

4. The law and practice of VC in Ukraine and beyond: evidence from interviews

In this part we present findings from our interviews. We begin by examining a number of issues of generic interest in the operation of VC in its European (including Ukrainian) context: the relational dimension of the control exercised by funds, the increasing use of flexible financing instruments combining equity and debt, approaches to exit, and the management of less successful firms. We then look at a set of topics which are more specific to the situation in Ukraine: the use by Ukrainian funds and startups of elements of foreign law, mostly in relation to corporate structure, and domestic law, where the focus is on employment and tax law; how far Ukraine's civil law legal origin operates as a constraint; the evolution of the wider VC ecosystem in Ukraine; and understandings of how the wider institutional environment in Ukraine interacts with substantive legal rules.

4.1 Relational control

For the funds we spoke to, how to ensure effective monitoring and oversight over portfolio firms was a key issue. However, funds rarely sought a controlling equity stake or a majority of board seats. Some of our interviewees rejected the language of 'control' altogether:

> The venture model is very much *not* about control, it is not like private equity, [venture capital] is very much, here are the funds, you deal with it don't do anything very structural without our consent, private equity is not like that (Lawyer, UK)

Funds saw an arms-length relationship as necessary to preserve founder autonomy:

> How much equity would the venture capital fund hold? Typically 20% depending on the valuation. Venture capital funds are focused on being founder friendly. They will want to determine how to proceed based on the number of founders and their current holders, they have to work out what would be reasonable in order to incentivize the founders and keep them on board? (Lawyer, UK)

Investors were cautious not to demand too much from founders. Even in a downturn when they 'have more power, they are in a better position to command terms', funds would avoid taking majority stakes because 'the founder needs to be motivated, a founder with tiny pieces doesn't work' (VC fund, Ukraine).

In place of a majority holdings, funds relied on other mechanisms to protect their position:

> Keeping control is important, but venture capital is about minority ownership, normally 20-30%, so a control mechanism is needed, a combination of a shareholders' agreement, reserved matters at board level and shareholder levels being specified, you might have

> for example the right to appoint a director, the board is not allowed to do certain things. (Lawyer, UK)

Pre-emption rights, board-level veto rights for the director nominated by the fund, and investor consents contained in the shareholders' agreement operate as negative constraints or guardrails:

> Imagine a road that could be straight or curvy, that road is the role of the management, they drive it forward, put on the brakes, the accelerator, they are driving it, the investors are the guardrails on the road, investor vetoes and investor consents. These work at two levels, two strata, they are negative controls, the fund can't force the company to do something but they can prevent it from doing certain things, bifurcation is at board level and at shareholder level so at board level most VC [funds] will want to have a board representative, board level consent is an issue, the board can't take certain actions without the consent of that director, at shareholder level, the shareholders can't do something without certain investors agreeing. My aim would be to keep operational matters at board level but keep matters affecting value at shareholder level. (Lawyer, UK)

The 'guardrails' were about stopping certain things from happening rather than making them happen:

> Venture capital is about negative covenants, you can't do something without our consent, not positive covenants, so the founder is only exposed if the investors control the board which is a risk for them, and the second line is if investors control the share structure, but that's not very likely, as VC companies grow there is a cycle, and there is a cycle with many rounds, series A, B, at each stage they release more funding, the founder is slowly diluted over time, so the concern only comes in after many dilutions. (Lawyer, UK).

Consents were seen as becoming increasingly common in the European context and were more important there than in the US, where there was greater reliance on the liquidity preference route to safeguard the fund:

> In the US the key economic lever is in the investment document, the liquidation preference. The US is based on a one-time non-participating liquidity preference. It means that if the company does not do well I may get my money back and if it does well we share, and that is becoming the norm in Europe, but not always, and downside protection is one times participating preference, the investor gets their money back first and then shares, that is fading away, it is much more about guardrails now, the US VC has low guardrails, but the European VC has high guardrails, in the US the number of consents matters. Maybe 8-10 issues whereas it can be as many as 30 for a European one. (Lawyer, UK)

While some funds preferred to take board seats, others were content with observer status, as this would be sufficient to generate the information they needed, and put them in a position to use their veto power when necessary:

> Being a board observer is important, we will go along to meetings, if after a couple of years we have reason to believe there is no problem we might then give up that right because we are adding more companies, even if some go bust the fund grows, and some of the board meetings can go on, the optimal meeting is one and a half hours but some

> are three hours if we have to go 60 meetings, well, it is not worth it. Getting this right is tricky, we often have to compete to get into good deals. (VC fund, UK)

4.2 Flexibility of debt and equity

Debt and equity were seen as increasingly interchangeable, with investors switching from one to another at different points in the funding cycle, according to changing risk profiles. Rather than take convertible preference shares, UK-based funds tended to supply convertible debt at the seed and early stage. Convertible loans had 'become more popular since the bubble burst in 2021' with the result that share prices were generally depressed and firms wanted to defer having an equity round (VC fund, UK). US-style SAFEs and their equivalents, advanced assured agreements, were also used. These instruments were seen as useful for the way they combined elements of debt and equity:

> For early stage, debt or access to debt is a luxury as they are not making any money at that point. Convertible debt, a quasi-debt instrument, means that the investors can invest without taking an equity stake. It is a way to deal with uncertainty, and if all goes well we can convert at a discount, it is about risk management, it is not debt per se, it is structured as debt to allow the investment go forward, an Advanced Assured Agreement is like a US SAFE, a simple agreement for equity. (Lawyer, UK)

The flexibility of debt was emphasised:

> Debt is different. Venture capital equity is like gambling, you've got to be prepared to lose your money so don't over complicate it… If you talk about debt, is it low risk, well it ranks above equity on a liquidation… so debt is a broad instrument. (Lawyer, UK)

Other interviewees emphasised the relational aspects of debt:

> If you are an investor, you won't get majority ownership, it is not how the model works, it is not private equity. The whole model is based on being not active investors but being a basic investor, you can influence how you can use informal methods to build relations, it's not really legal leverage… When Series A round companies try to raise money through convertible notes and safe notes, then investors have no rights, it is founder friendly… (VC fund, UK)

The logic of this last observation is that with convertible notes and SAFEs, investors have little or no control over the company until conversion happens; during this period, founders retain decision making power. The 'braiding' of formal and informal rights, rather than formal rights alone, explains the nature of the fund-startup relation.

4.3 Exit dynamics

Exit via an IPO might be an ideal but it was easier to 'fantasise' about it than to 'plan it', there had to be a very specific 'window of opportunity' in terms of market conditions and the size of the deal, and current conditions were not right, 'the IPO is super-dependent on cash flow and rates of return, not good in a high interest rate world' (VC fund, Ukraine). The IPO route was seen as 'hard', 'super complicated', 'very expensive, a bit broken' (VC fund, Ukraine). Early-stage investors were unlikely to get to the listing stage very often, more likely would be selling out to a larger firm in the same sector,

or, as was becoming more common in the UK market, a private equity fund. Trade sales were seen as flexible for founders as they could remain involved post-merger. For the shareholders, a trade sale was often preferred as it could give them a 'full exit' in contrast to a listing or share sale (Lawyer, UK). Taking up shares in a merged company was not risk-free for a fund:

> A big US venture-backed company bought [one of our portfolio companies], there was some uplift, a good story, a validation of our approach, that was for shares, so now we have shares in the US company, for that we had to give up anti-dilution and observer rights, and that can be tricky. (VC fund, UK).

Elements of a power-law dynamic could be observed:

> We very much expect some [portfolio firms] to fail and one or two to make 10 times our money back, or more since over time, the majority will fail, or we will exit for less than we invested so we are looking for an investment that will make up for that, one that goes up 25 times by value, if you have 4% then everyone gets their money back, and that is nirvana, that is why we are always looking at the product market, if there a big market that is the first thing we look at, a £100 million market is too small if the market share is only 5%. We haven't had one like that yet but that is our model. (VC fund, UK)

> Out of 10 startups, one will super perform, maybe 2, then 2-3 on average get their money back, maybe 4, and the rest will fail, and there is an acceptance of this, a high proportion will fail, and with different investors involved, it's straight betting. (Lawyer, UK)

However, actually achieving a portfolio-wide return from just one investment was seen as unusual. More likely in practice was a situation in which returns could be obtained from a proportion of portfolio firms, rather than a few hyper-successful ones: 'we are not just aiming for a single successful exit' (VC fund, Ukraine). In some funds, in less high-risk sectors, the goal was to achieve moderate to high returns in a sizable segment of the portfolio firms:

> How many startups actually succeed? It varies hugely from fund to fund. Some are investing at very early stage in deep tech. Very, very risky, but when it works it pays big time, one in ten, in AI for example. Some funds will want less spectacular returns from a larger number of companies, a slightly different bet, maybe a third do very well, a third ok, a third fail. Later stage is less of a risk, less lucrative. (Lawyer, UK)

Some interviewees perceived a difference in the approaches of US and European funds:

> How many actually succeed? There is a difference in approach between US and Europe, it is a different philosophical approach. With US VCs, there is some change over time but a US VC out of Silicon Valley, they would invest in ten and of those five will go belly up and they expect that but of the remaining five, two may do ok, and get your money back, another one or two, twice your money back, and just one or two will make your returns. The European approach is to invest in ten, you don't want to lose money on most of them, even if only one or two on average get you your money back. It's a different risk-reward profile, so what that means is, when you draft the documents, the US focus is on the upside, the European approach is the downside, control the downside risk. (Lawyer, UK)

4.4 Managing less successful firms

This diversity of outcomes within a portfolio was reflected in the way that funds managed their less successful investments. Funds accepted the need for patience in assessing portfolio firms, and would sometimes emphasise the need to avoid becoming profitable too soon:

> Some companies will be cash flow positive, that may be ok, they may have a partial exit. We expect one or two to work out. But it's not good if some make a return straight away, it would be too soon. They won't grow. Maybe some will exit in the next two to three years. We will wait, and it is a game we are playing. In some funds, one in fifty, one in a hundred may be really big, and five or six may make five times the investment, but that is not a target for us. We are aiming for fifty companies to invest in eventually. (VC fund, UK).

Less successful firms were not simply written off. A significant proportion of companies in a portfolio could end up as 'zombie or lifestyle companies, no exit, doing well but never looking to have an IPO or sale, perfectly fine, they tick over, but the investors get frustrated' (Lawyer, UK). While there might be a redemption term in a shareholders' agreement allowing the fund to redeem it shares or force the company to do so, this was not regarded as normal and might be difficult to enforce in practice. Funds would try to avoid an insolvency ('like Voldemort, it shall not be named') and it was becoming more common to see acqui-hires, 'an insolvency which is masked as a sale…, an acquisition where you are effectively hiring the engineers, the buyer will pay £1 to take over the human skills' (Lawyer, UK).

4.5 Use of foreign law: corporate structure and commercial contracting

Ukrainian entrepreneurs going down the VC routes either choose to incorporate their business in an overseas jurisdiction of the kind that is known for having a flexible company law, such as English or Delaware law, or operate via a Ukrainian subsidiary which is wholly owned by a holding company incorporated overseas, normally in Delaware. This is done, we were told, in order to attract international investors:

> Ukrainian legal entities were not and are not fundable, international investors don't feel comfortable that their rights will be protected, Ukrainian law is not the most protective way to structure this, and the court system, there are issues, that is why startups try to find solutions, they need other solutions, for banking also, so people come to us, we give an overview of countries with VC friendly regimes, flexible corporate laws, it is about the convenience of the corporate law and the possibility to operate remotely, e.g. having a company registered in Delaware or the UK, issuing shares etc., the more flexible the process the more it can be structured to be attractive to investors. (Entrepreneur, Ukraine).

The legal processes are well understood and their application is not confined to Ukraine:

> So far as the particular legal challenges are concerned, the key thing in VC is to attract those non-domestic investors by facilitating a legal structure that works for them. In most jurisdictions that means enabling an external investor to use a holding company in Delaware or elsewhere in US or UK, maybe in the Netherland or Caymans, or Cyprus,

> that's the way in which a lot of these investments are made, and I do these every day not just into English VC but also South Africa and also for Nigeria, Slovenia the Baltics. What they have in common is a US or UK holding company and that reduces the friction in terms of familiarity with the legal system and all those things. So they will still need to worry about the domestic situation but there are fewer concerns, so the holding company is the sole shareholder of for example a Lithuanian or Ukrainian company. The operating company is in the Ukrainian jurisdiction. (Lawyer, UK)

Thus the process is driven by a combination of familiarity with the relevant background laws and corporate forms and the transactional flexibility offered by the underlying common law in the US and UK. Ukrainian law is regarded as less familiar and less malleable than these common law alternatives. At the same time, there is a recognition that relying so completely on overseas law carries some costs. There must be a foreign element to the investment for the choice of overseas law to be recognized by the Ukrainian courts, and while this is not in principle a problem where cross-border investments are being made, contracts made wholly between Ukrainian persons or entities may remain within the domestic jurisdiction. In for Ukrainian entities to take advantage of foreign law, it was necessary to have elements of domestic law which would allow cross-border legal transactions take place at low cost:

> What is needed for Ukraine is a company law that facilitates, and a tax law that facilitates, the holding company structure, not just for corporate governance but also from a tax law viewpoint, flipping will be crucial. In Germany, post-Brexit, not all the mechanisms are in place to flip a German company into an English company in a tax efficient way, so they are tending to go to the US. So Ukrainian company law is still important. (Lawyer, UK)

There was also a perception that relying on overseas law, while a necessary short-term solution to promote inbound investment, will have a detrimental effect on the development of the domestic legal framework, and may mean missing out on the wider ecosystem-level benefits of having a thriving VC sector. There was some scepticism on the suitability for Ukraine, over the longer term, of the Israeli model of VCs relying on foreign law and a US listing:

> So I am not a proponent of that kind of model which is the Israeli model, the startup fund, if it is not registered in the Ukraine you can't get it financed, well that is outdated, it does not correspond to reality now, and ignores the wider context of fund-raising. For Series A, we need to explore the exponential opportunities, that is the issue with successful startups. We have hundreds of Ukrainian startups struggling to raise money. (Entrepreneur, Ukraine)

4.6 Use of domestic law: employment and tax

In the case of tax and employment law there is less scope for using foreign law than there is in the case of corporate structure and commercial contract law, so the content and operation of domestic laws in these areas can be important in practice for the legal structuring of both funds and startups. As far as funds are concerned, there would appear to be elements of forum shopping involved in the operation of tax laws, with some funds, we were told, choosing to incorporate in low-tax regimes including Ireland and Luxembourg. In the UK, the tax rules applying to funds structured as venture capital trusts, under which investors qualify for immediate tax relief, were regarded as having been important for stimulating early stage VC.

For the most part, the tax law which startups need to consider is the domestic law of the country in which their operations are based. How a share swap is regarded for tax purposes can become a critical issue, which is not entirely resolved by the use of an overseas holding company:

> If you have a new Ukrainian tech company trying to raise from a US VC, the US VC wants to invest, and says, you must be an English or US company, the Ukrainian shareholders must exchange their shares in the Ukrainian company for the shares in the holding company in the US or UK so the big issue to ensure that the exchange of shares is not a taxable event, not a crystallisation of a capital gain, or an exit tax as in Germany, and this is a problem in Germany, they call it dry tax, shareholders just swapping paper for paper, so what would facilitate investment is an effective flipping rule, because not to have that would be prohibitive, so that is an issue for a Ukrainian company. (Lawyer, UK)

In addition, how income from employment is taxed, and whether capital gains are charged on share allocations and share options, are important issues when it comes to incentivizing employees. Tax law interacts at this level with domestic rules of employment law, which can be more or less flexible in terms of how they regulate the substance of hiring and dismissing workers, and to what extent they allow forms of gig work contracting and consultancy agreements to be made which take the supply of services outside the scope of labour laws. The apparent inflexibility of employment laws in some mainland European jurisdictions, including France, Germany and Italy, was cited by some of our interviewees as a disincentive to investing there.

While seeking flexibility over hire-and-fire rules, funds also use employment contracts strategically, as a way of locking in the founder and core staff of the startup. The employment contract agreed with the founder will generally contain intellectual property clauses and covenants which are designed to penalize their premature departure. In English law, garden leave clauses and restrictive covenants are regularly enforced and can shape negotiations when the fund first invests and subsequently over the funding cycle:

> Employment contracts are important, they have to be governed by English law, this is important along with founder shares. Employment contracts get enforced, yes. If the founder leaves there is negotiation, it is rare to go to all the way to enforcement. You can have good leavers and bad leavers, who wants to be a bad leaver? We had a case where we got to the final negotiation to invest and the company was arguing about various things we were debating with them, one of the three co-founders wasn't sure but we weren't giving up, we knew we would look like idiots if the founder left three months later. Then they left the room, 45 minutes later they came back, they told us that the chief technology officer was handing in his notice and would leave in three months! We did not invest, the employment contract issue had flushed out potential risk. (VC fund, UK)

UK funds can also seek a covenant in the shareholders' agreement as a way of stopping the founder 'upping sticks'. Since the founder will also be a shareholder, a restrictive covenant in the shareholders' agreement will further mitigate the risk of hold-up: 'you can take shares away from the founder if they leave, at unattractive prices, so they are locked in' (Lawyer, UK).

Employment law in Ukraine is seen as complex but also layered in ways which allow startups a high degree of flexibility in practice. Hiring employees under the labour code requires the payment of regular wages and salaries, and comes with mandatory rules on holidays and sick leave. For some Ukrainian interviewees this was an 'old, bad system for how to work with people' (startup, Ukraine), although for others 'you have laws to protect people and that is how it should be, there should be

reasonable protections' (official, Ukraine). Recent reforms to Ukraine's labour code were welcomed even if 'its spirit remains Soviet style'.

In practice, firms have several options available to them if they want to avoid the application of the general labour law. Gig work arrangements are widely used across the tech sector and the Diia City regime makes it possible to employ engineers and IT workers as consultants or independent contractors. The low flat-rate income tax charged under the Diia City rules was seen as helpful:

> Employment law is not really an issue, Ukraine has a good system, the startup employs people under private contracts, tax is not a problem, the government has not been going after people, the tax authorities don't go after single employee entities and try to treat those as employment contracts (VC fund, Ukraine).

Several interviewees commented on the importance of getting the right mix of employment and tax laws for a sustainable VC ecosystem to develop in Ukraine:

> Employment law would have to be local, it is one of the things I'd like to flag. Where the employee is located is key, you would want to have all the engineers employed by the Ukrainian entity and under Ukrainian law, so the key is to know that Ukrainian employment law gives adequate protection for IP, the company must own it. Two other critical things, which are part of the ecosystem, equity incentives are also needed for employees, you would want to ensure that the equity incentives are not inefficient, this is a big problem in some other jurisdictions, it is all about the growth of the company. (Lawyer, UK)

The Diia City regime, while offering flexibility, also had some drawbacks:

> if you employ independent contractors, you don't pay tax, but it can be complex, the independent contractor must have a legal entity, and it is hard to control them, and in case the employer has the control right, so then you may end up paying the tax, so in my company if I have five independent contractors I have to get the accountant to organize the payment five times, it can be a bit stupid, why you should need to use this scheme. (Startup, Ukraine).

Using workarounds was potentially problematic from the point of view building a sustainable businesses:

> You can work informally, through independent contractors, before you register a company, but this year we decided, as a value decision, to set up the company with employees, we may lose a part of the profit now but in future we will make more, so now we have a real company with employees not independent contractors, it is an opportunity to lose now but earn much more in future. (Entrepreneur, Ukraine)

4.7 Civil law origin

Opinions diverged on how far civil law legal origin posed a problem for the development of VC in mainland European countries including Ukraine. While interviewees regularly emphasised the importance of having a flexible and malleable legal base for transactions, they did not necessary associate the civil law with undue rigidity. The preference for using certain legal devices and transactional devices associated with VC was more to do with familiarity with the US model with which VC began than with the legal divide between the common law and the civil law:

> The US model has worked well, so there is some convergence on that. It's more of a move to a US-style approach, it is not the common law as such. That can be done in a civil law system just the same way, and it will be when it is US investors coming in, and they bring their approach with them. (Lawyer, UK)

If there was a problem with the civil law it was not any supposed rigidity of legal forms as the delays which were likely to arise when using a notary public to sign off on documentation, which remains mandatory in some countries. These difficulties could largely be avoided by using a US or English-law holding company:

> I am not aware of a single US VC investing directly into a Lithuanian or Estonian company, they use the holding company, they need to be able to extract in a tax efficient manner, it is crucial to have this. (Lawyer, UK).

4.8 Ecosystem-wide effects

The benefits of having an ecosystem containing interlinked networks of public and private sector institutions were emphasised by several interviewees. Important elements of ecosystems were accelerators, such as Y Combinator in the US and Enterprise First in the UK. These were important as focal points for bringing together funds and companies, often entrepreneurs who set up funds after having succeeded with a startup:

> what do they do, in an ecosystem they condense or focus the energy, founders who made money come back in, VC funds, it's melting pot, you are more likely to create a successful company this way, they are very important where the VCs keep an eye on this channel of credible companies. (Lawyer, UK)

Also important were universities. Technology transfer offices and incubators helped create a community based approach, alumni help, networking, credibility, 'there is some signalling' (Lawyer, UK). In addition, trade associations could assist in developing term sheets and standardised documentation, which helped establish a common knowledge base and build trust. In the UK context,

> The BVCA term sheets were very important people coalesced around them, to avoid people going back to first principles, they were very helpful in avoiding the situation in which people just have to start from a blank piece of paper. (Lawyer, UK)

A further dimension of ecosystem effects concerned the need to build networks and structures that were not based wholly offshore. It was recognised that using an overseas law as the basis for

corporate and commercial forms ran the risk of missing out on the network effects of having an onshore legal sector and local role models:

> Having a suitable vehicle is essential for an onshore industry. Most Luxembourg funds go elsewhere. But if you want a thriving local industry you need this for the economy of the country, it attracts not just the head office but also, advisers UK lawyers benefit if the structure is UK, accountants, etcetera, the ecosystem develops around the jurisdiction, and there is some academic evidence that funds do invest closer to home, so UK funds do invest locally. So there is an argument for potential benefits there. Most jurisdictions do try hard to get this right. (Lawyer, UK)

It would be important overtime for successful entrepreneurs to return to Ukraine to support local networks:

> The tech ecosystem is driven by founders, and VC money attracts more money, it becomes a living system, you find concern over outflow of funds but that is minimised by having local champions, because the local champions will want to get back to Ukraine, to build and to contribute, now the US VCs may have capital that flows back to LLPs, but still there is money in the system. (Lawyer, UK)

In the 'short term' a country with a young and developing VC sector such as Ukraine would have a need for foreign law to support inbound investment, but in the 'long term you do need to develop the local legal framework, in the long term you can't really have this bifurcation' between domestic and foreign law (Lawyer, UK).

4.9 Institutional quality

There was a widespread acknowledgement that corruption was a barrier to the movement of capital into Ukraine and a major factor in the use of foreign legal structures to provide reassurance to investors. There was a perception that corruption operated on the basis of expectations which had become self-reinforcing:

> if you operate here in the UK, you don't need to have a budget for bribing, it is insane to have to do that, but people get used to bribing in Ukraine so it opens a whole load of opportunities for them, this is the problem, making money from corruption, this is the bottleneck for any further investments of a serous kind in Ukraine. (Lawyer, UK)

Reasons for the persistence of corruption included the legacy of Soviet-era laws, 'designed for a completely different economic system' (Entrepreneur, Ukraine), which could be over-rigid in their operation, 'the post-Soviet legacy was one of, lots of procedure, bureaucracy, not very evolved with respect to private property rights, and also, just not a particularly well aligned legal framework when it comes to dealing with commercial law questions' (Lawyer, UK). Another factor was the continuing influence of oligarchs, the opposite of entrepreneurs:

> Gates, Musk are not oligarchs, the oligarch takes control of some resources, this is a part of manipulation of privatization, post-Soviet Union, and uses corruption, embedded corruption from 30 years ago, and it is corruption today, but then back then it was legal. (VC fund, Ukraine)

These factors were, however, fading, as the remnants of Soviet laws were removed, and oligarchical influence waned, a process which the war with Russia had accelerated. Wartime conditions, which introduced a degree of 'autocracy' into government, meant that 'it is hard to overpower anything that comes from the people who are in governing in the broad sense', but this too could be expected to pass.

Other factors expected to mitigate or reduce corruption over time were growing alignment with European Union laws and standards, the return to Ukraine of entrepreneurs who had been successful overseas, training of judges and bureaucrats, the growing influence of a younger generation less tolerant of graft, and the public shaming of corrupt practices, which an independent anti-corruption body, of the kind which had operated with success in other east central European countries, could take forward.

There was also discussion of whether the use of workarounds and exemptions from the general law, designed to help foster VC by exempting certain arrangements from the general law, would have a positive or negative impact on corruption. Diia City, 'the core idea of which is a free zone with a common law system', offered advantages in terms of legal flexibility, and could develop further in future if the model of similar international financial centres making use of English law, in Dubai and Kazakhstan, were followed (VC fund, Ukraine). On the other hand, 'we would prefer general Ukrainian law to be of good quality', and using foreign law ran the risk of the country missing out on network effects, 'the country loses if everyone leaves Kyiv for Lisbon, just taking their laptop (official, Ukraine). Some saw the use of carve-outs as potentially detrimental:

> We can outsource 20 people and it is cheaper that way and we operate at a discount but I don't want this, I want to build a business with everything official, I want to pay all my taxes and sleep well at night, I don't want to be part of corruption, part of some optimization scheme, of course I could optimize, I won't pay tax if my expenses are more than my income… I pay zero tax that is ok, but if I work with only independent contractors that is not ok, I need talented people for modern European and US markets, I don't need to hide my revenue, I don't need to optimize my revenue in a grey way, I want to go the US like a businessman not a tourist. (Entrepreneur, Ukraine)

Growing commercial exchange with the rest of Europe was seen as a factor likely to shift attitudes over time. It made a difference that 'we see from the west that people are used to paying taxes'. There had to be

> a different mentality now that the Ukrainian tax system is interlinked with the European one, there are laws all in place, but it is brand new, no tradition, we have to learn how to pay taxes..., this is the tradition that has to be built, private property, and investment, tradition, not law alone, we have law but we need a tax collection and payment tradition and yes I guess those two are the key' (VC fund, Ukraine).

5. Assessment

In principle, VC funding requires a legal framework that minimises transaction costs among various stakeholders, including investors, founders and employees, and is adaptable enough to align their interests over the funding cycle. The wider benefits of VC funding include the generation of cognitive assets and their diffusion across a wider ecosystem linking funds and startups to public agencies including research organisations and universities. The formal elements of VC contracting, which can appear to emphasise the control and monitoring roles of the fund, coexist or are 'braided' with informal elements based on repeat trading between actors who may switch roles entrepreneurs, investors and advisers, assisting reputation-based enforcement, and the generation of trust at ecosystem level.

Our interviews highlight the interaction of the formal and the informal which is characteristic of the 'braiding' phenomenon. They suggest that the fund-startup nexus is essentially relational rather than solely control-orientated, and in some context is even the antithesis of the close control which is associated with alternative governance modes such as private equity. In common with other studies we identified the fluidity of debt and equity as modes of financing and their growing interchangeability. Exit dynamics reflect the 'power law' of exponential returns from a small minority of firms, but this may be tempered in the European context, with less extreme outcomes at either end of the distribution. VC funds can support lifestyle companies and arrange exits via acqui-hires, alongside more spectacular successes. In the conditions of a market downturn, when we conducted our interviews, IPOs were rare compared to the more normal trade sale route to exit, but it would seem that even in better times the IPO is no longer the sole or even more common route to realising investments.

It is evident that VC investments into Ukraine face significant challenges. To some degree these are typical of European VC more widely. There are several respects in which mainland European legal systems are not aligned with the US model of VC. Convertible preferred stock, the predominant investment mode for US VC, is not always available to European investors, and shareholder agreements may not be straightforwardly enforceable where they conflict with background rules of company law. Across European jurisdictions, it has become common to observe bespoke contractual arrangements being put in place in an attempt to make up for the absence of company law rules and transactional devices which are part of the US model.

How far this leaves European legal systems out of line with the needs of VC is not straightforward to assess. Although it is widely believed that misalignment of European corporate law regimes with the US template puts European VC at a disadvantage, this may be to put too much emphasis on the role of particular US legal and contractual arrangements in driving VC. Functional equivalents to convertible preferred stock, including convertible debt various kinds, are in wide use in Europe, along with local equivalents to standard form instruments such as the US-origin SAFEs and KISSes. Tax law regimes have been aligned to VC needs in several jurisdictions, including Ukraine, through changes to capital gains and income tax laws, and employment law has been rendered more flexible by the use of gig work contracts and the ease which labour services can be outsourced to external contractors.

In so far as Ukraine corporate law remains out of line with VC needs, the gap may be filled by reliance on overseas legal systems to supply the basic VC template. Virtually all Ukraine-based startups are either incorporated in US or English law or operate through a US or English-law holding company. If they have a target exchange for an IPO it will most often be NASDAQ. Thus in common with VC sectors in many other countries, startups in Ukraine are in a position to take advantage of the transactional flexibility of US corporate and commercial contract law. While tax law and employment law are not

so easily customised, changes made in these areas, both as a matter of general law and also through the 'free zone' of Diia City, have helped to create a legal environment more conducive to VC.

Use of foreign law for corporate and commercial transactions and the Diia City workaround for employment and tax law offers a plausible route for the development of Ukrainian VC, but their potential positive effects may be time limited. Over reliance on foreign law and legal carve outs runs the risk of missing out on the wider ecosystem benefits of VC, as critical legal and financial skills remain offshore. Workarounds, whatever their other benefits, may come at the cost of the uniform application of general legal rules, the expectation of which is a key part of building an enduring rule of law. In the medium to long term, institution-building, in which a vibrant VC sector can play a role, is likely to be of equal importance to crafting specific legal rules and transactional devices to attract investment.

6. Conclusion

This report has examined the legal framework for venture capital in Ukraine. We conducted a review of relevant laws and carried out interviews with VC practitioners to obtain evidence on how VC in Ukraine and more generally in European jurisdictions was working. We also drew on indices of Ukraine's legal development and wider progress towards the practice of the rule of law.

In common with countries elsewhere in Europe and more generally, Ukraine has recently initiated a number of legal reforms designed to encourage VC-based financing of innovative firms. In addition to changes made to the general law governing corporate entities, insolvency and employment, a special legal regime applying to IT-based startup, the Diia City free zone, has been introduced. This makes available many of the transactional devices use to support VC in the USA and elsewhere, although doubts remain over the compatibility of Diia City rules with those of general corporate law. In practice, any shortcomings of Ukrainian domestic law can be addressed through the use of foreign law. Ukrainian startups are usually incorporated in US (Delaware) law or with a US parent, using procedures which are tried and tested from the experience of other jurisdictions. Use of foreign law for corporate and commercial transactions, coupled with a favourable tax and employment law regime at the level of domestic law, offers a pragmatic route to building Ukraine's VC sector, at least in the short term. In the medium to long term, inshoring of legal and professional services will assist in developing a wider VC ecosystem, capable of generating knowledge spillovers.

While the substance of Ukrainian law is increasingly aligned with what is needed to promote VC, the wider institutional environment is currently less amenable to it. Over the past decade Ukraine has made relatively slow progress in improving its rule of law performance by the standards of other east central European countries. Special structures designed to support VC have been used for ulterior ends, as ways to minimise tax in non-innovative sectors, such as real estate, and to conceal corporate ownership. The use of carveouts and workarounds designed to support VC runs the risk of undermining the operation of general legal rules. Consideration should be given to these wider institutional spillovers going forward.

References

Abrahamsen, R. (2012) 'The seductiveness of good governance'. In J. K. Sundaram and A. Chowdhury (eds.) *Is Good Governance Good for Development?* 1st ed. pp. 29–52 (London: Bloomsbury Academic).

Alesina, A., Özler, S., Roubini, N. and Swagel, P. (1996) 'Political instability and economic growth' *Journal of Economic Growth*, *1*(2): 189–211. https://doi.org/10.1007/BF00138862.

Aoki, M. (2010) *Corporations in Evolving Diversity* (Oxford: OUP).

Armour, J. (2002) 'Law, innovation and finance: a review' CBR working paper no. 243.

Armour, J. and Cumming, D. (2006) 'The legislative road to Silicon Valley' Oxford Economic Papers, 58: 596-635

Barro, R. J. (1996) 'Determinants of economic growth: a cross country empirical study' NBER WP 5698 https://www.nber.org/papers/w5698.

Bhagat, S. and Wittry, M. (2020) 'Economic growth, income inequality, and the rule of law' Working Paper University of Boulder https://leeds-faculty.colorado.edu/bhagat/RuleLaw.pdf.

Bian, B., Yingxiang, L. and Nigro, C. (2022) 'Conflicting fiduciary duties and fire-sales of VC-funded startups' Lawfin WP No. 35.

Black, B. and Gilson, R (1998), 'Venture capital and the structure of capital markets: banks versus stock markets' 47 *Journal of Financial Economics* 243-277.

Bonini, S. and Alkan, S. (2012) 'The political and legal determinants of venture capital investments around the World' *Small Business Economics*, 39: 997–1016.

Borovyk, A. (2020) 'How to solve Ukraine's constitutional crisis' Transparency International https://www.transparency.org/en/blog/how-to-solve-ukraines-constitutional-crisis

Botero, J. C., Pinzon-Rondon, A. M. and Pratt, C. S. (2016) 'How, when and why do governance, justice and rule of law indicators fail public policy decision making in practice?' *Hague Journal on the Rule of Law*, 8(1): 51–74.

Botero, J. C. and Ponce, A. (2011) 'Measuring the rule of law' Working Paper, World Justice Project. Available at SSRN: https://ssrn.com/abstract=1966257.

Bottazzi, L., Da Rin, M. and Hellmann, T. (2016) 'The importance of trust for investment: evidence from venture capital' *Review of Financial Studies*, 29: 2283–2318.

Bratton, W. (2002) 'Venture capital on the downside: preferred stock and corporate control' *Michigan Law Review*, 100: 891-945.

Brunetti, A., Kisunko, G. and Weder, B. (1998) 'Credibility of rules and economic growth: evidence from a worldwide survey of the private sector' *World Bank Economic Review*, 12(3): 353–384. https://doi.org/10.1093/wber/12.3.353.

Bruton, G. and Ahlstrom, D. (2003) 'An institutional view of China's venture capital industry' *Journal of Business Venturing*, 18: 233–259.

Bruton, G., Fried, V. and Manigart, S. (2005) 'Institutional influences on the worldwide expansion of venture capital' *Entrepreneurship Theory and Practice*, 29: 737–760.

Bratton, W., and Wachter, M. (2013) 'A theory of preferred stock' *University of Pennsylvania Law Review*, 161: 1815-1906.

Broughman, B., and Fried. J. (2013) 'Carrots and sticks: how VCs induce entrepreneurial teams to sell startups' *Cornell Law Review*, 98: 1319-1358.

Broughman, B. and Wansley, M. (2023) 'Risk-seeking governance' *Vanderbilt Law Review*, 76: 1299-1378.

Carothers, T. (2006) 'The problem of knowledge', in T. Carothers (ed.) *Promoting the Rule of Law Abroad: In Search of Knowledge* pp. 15–28 (Carnegie Endowment for International Peace).

Claessens, S. and Laeven, L. (2003) 'Financial development, property rights, and growth' *Journal of Finance*, 58(6): 2401–2436. https://doi.org/10.1046/j.1540-6261.2003.00610.

Clarysse, B., Knockaert, M. and Wright, W. (2009) 'Benchmarking UK venture capital to the US and Israel: what lessons can be learned?' Report prepared for the British Private Equity and Venture Capital Association (BVCA) (London: BVCA).

Connell, D. (2017) *Leveraging public procurement to grow the innovation economy. An independent review of the Small Business Research Initiative* (London: DBT and DBEIS).

Cumming, D. (2011) 'Misinforming the public about public policy towards venture capital' *Venture Capital*, 13: 99–102.

Cumming, D. and Johan, S. (2014) *Venture Capital and Private Equity Contracting* 2nd. ed. (London: Elsevier).

Da Rin, M., Nicodano, G. and Sembenelli, A. (2006) 'Public policy and the creation of active venture capital markets' *Journal of Public Economics*, 90: 1699–1723.

Davis, K. E. (2004) 'What can the rule of law variable tell us about rule of law reforms' *Michigan Journal of International Law*, 26(1): 141–162.

De La Croix, D. and Delavallade, C. (2011) 'Democracy, rule of law, corruption incentives, and growth' *Journal of Public Economic Theory*, 13(2): 155–187.

Deakin, S., Gindis, D., Hodgson, G., Huang, K. and Pistor, K. (2017) 'Legal institutionalism: capitalism and the constitutive role of law' *Journal of Comparative Economics*, 45: 188-200.

Deakin, S., Armour, J. and Siems M. (eds.) (2023) *CBR Leximetric Datasets [Updated]* https://doi.org/10.17863/CAM.9130.2.

Dollar, D. and Kraay, A. (2003) 'Institutions, trade, and growth' *Journal of Monetary Economics*, 50(1), 133–162.

Edgardo Campos, J., Lien, D. and Pradhan, S. (1999) 'The impact of corruption on investment: predictability matters' *World Development*, 27(6): 1059–1067. https://doi.org/10.1016/S0305-750X(99)00040-6.

Enriques, L. and Nigro, C. (2023) 'Corporate law and venture capital in Italy: what does the empirical evidence (really) tell us?' *Oxford Business Law blog* 16 November 2023 https://blogs.law.ox.ac.uk/oblb/blog-post/2023/11/corporate-law-and-venture-capital-italy-what-does-empirical-evidence-really.

European Commission (2023) 'Ukraine 2023 Report' Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions SWD(2023) 699 final.

Gilson, R. (2003) 'Engineering a venture capital market: lessons from the American experience' *Stanford Law Review*, 55: 1067-1103.

Gilson, R. and Black, B. (1999) 'Does venture capital require an active stock market?' *Journal of Applied Corporate Finance*, 47: 243-77.

Gilson, R. and Schizer. D. (2003) 'Understanding venture capital structure: a tax explanation for convertible preferred stock *Harvard Law Review*, 116: 874-916.

Gilson, R., Sabel, C. and Scott, R. (2009) 'Contracting for innovation: vertical disintegration and inter-firm collaboration' *Columbia Law Review*, 109: 431-502.

Gilson, R., Sabel, C. and Scott, R. (2010) 'Braiding: the interaction of formal and informal contracting in theory, practice and doctrine' *Columbia Law Review*, 110: 1377-1447.

Gilson, R., Sabel, C. and Scott, R. (2011) 'Contract, uncertainty and innovation' Columbia University Law School, Law & Economics Research Paper Series No. 385, Stanford University Law School, Law and Economics Research Paper Series Paper No. 403.

Ginsburg, T. (2011) 'Pitfalls of measuring the rule of law' *Hague Journal on the Rule of Law*, 3(2): 269–280.

Gisselquist, R. M. (2012) 'Good governance as a concept, and why this matters for development policy' Working Paper 2012/30; Issue 2012/30. World Institute for Development Economics Research (WIDER). https://www.econstor.eu/handle/10419/81039.

Giudici, P., Agstner, P. and Capizzi, A. (2022) 'The corporate design of investment in startups: a European experience' *European Business Organization* Review, 23: 787-820.

Gompers, P. (1995) 'Optimal investment, monitoring, and the staging of venture capital' *Journal of Finance*, 50: 1461-1489.

Grilli, L., Latifi G. and Mrkajic, B. (2019) 'Institutional determinants of venture capital activity: an empirically driven literature review and a research agenda' *Journal of Economic Surveys*, 33: 1094-1122.

Hain, D., Johan, S. and Wang, D. (2016) 'Determinants of cross-border venture capital investments in emerging and developed economies: the effects of relational and institutional trust' *Journal of Business Ethics*, 138: 743–764.

Hammergren, L. (2008) 'Twenty-five years of Latin American judicial reforms: achievements, disappointments, and emerging issues' *Whitehead Journal of Diplomacy and International Relations*, 9(1): 89–194.

Hodgson, G. (2016) *Conceptualising Capitalism: Institutions, Evolution, Future* (Chicago: University of Chicago Press).

Hongdao, Q., Mumtaz, A., Mukhtar, H., Saleem, H. A. R. and Azam, S. (2018) 'Corruption prevention and economic growth: a mediating effect of rule of law' *International Journal of Social Science Studies*, 6(2): 128–143.

Humphreys, S. (2010) *Theatre of the Rule of Law: Transnational Legal Intervention in Theory and Practice* (Cambridge: Cambridge University Press).

Hyde, A. (2005) 'Silicon Valley's high velocity labour market' *Journal of Applied Corporate Finance*, 11: 28-37.

Jennejohn, M. (2008) 'Collaboration, innovation, and contract design' Stanford Journal of Law, Business and Finance, 14: 83-150.

Kaplan, S. and Strömberg, P. (2003) 'Financial contracting theory meets the real world: an empirical analysis of venture capital contracts' *Review of Economic Studies*, 70: 281-315.

Kaplan, S., Martel. F. and Strömberg, P. (2007) 'How do legal differences and learning affect financial contracts?' NBER WP 10097.

Keefer, P. and Knack, S. (1995) 'Institutions and economic performance: cross-country tests using alternative institutional measures' *Economics and Politics*, 7(3): 207–228.

Keefer, P. and Knack, S. (1997) 'Why don't poor countries catch up? A cross-national test of an institutional explanation' *Economic Inquiry*, 35(3): 590–602.

Lalafaryan, N. (2023) 'Private credit: a renaissance in corporate finance' *Journal of Corporate Law Studies*, forthcoming.

La Porta, R., Lopez-de-Silanes, F., Pop-Eleches, C. and Shleifer, A. (2004) 'Judicial checks and balances' *Journal of Political Economy*, 112(2): 445–470.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. (1998) 'Law and finance' *Journal of Political Economy*, 106: 1113-1155.

La Porta, R., Lopez-de-Silanes, F. and Shleifer, A. (2008) 'The economic consequences of legal origin' *Journal of Economic Literature*, 46: 285-332.

Lerner, J. (1995) 'Venture capitalists and the oversight of private firms' *Journal of Finance*, 50: 301-318.

Lerner, J. and Schoar, A. (2005) 'Does legal enforcement affect financial transactions? The contractual channel in private equity' *Quarterly Journal of Economics*, 120: 223-246.

Lin, L. (2020) 'Contractual innovation in China's venture capital market' NUS Law Working Paper 2020/004.

Martin, R., Sunley, P. and Turner, D. (2002) 'Taking risks in regions: the geographical anatomy of Europe's emerging venture capital market' *Journal of Economic Geography*, 2: 121-50.

Mauro, P. (1995) 'Corruption and growth' *Quarterly Journal of Economics*, 110(3): 681–712.

Messick, R. E. (1999) 'Judicial reform and economic development: a survey of the issues' *World Bank Research Observer*, 14(1): 117–136.

Møller, J., & Skaaning, S.-E. (2011) 'On the limited interchangeability of rule of law measures' *European Political Science Review*, 3(3): 371–394

Nigro, C. and Enriques, L. (2021) 'Venture capital e diritto societario italiano: un rapporto difficile' *Analisi Giuridica della Economia*, 1: 149-206.

Nigro, C., and Güzlügöl, A. (2022) 'Building an EU venture capital market: what about corporate law?' in G. Gimigliano and V. Cattelan (eds.) *Money, Law, Capital, and the Changing Nature of the European Union* (Oxford: Hart).

Nigro, C. and Maltese, D. (2022) 'Private equity, fusioni e rinuncia all'appraisal right: note su un caso statunitense con cenni all'esperienza italiana' *Rivista di diritto societario*, 16: 631-678.

Nigro, C. and Stahl, J. (2021) 'Venture capital-backed firms, unavoidable value-destroying trade sales, and fair value protections' *European Business Organization Review*, 22: 39-86.

OECD (2024) *Review of Anti-Corruption Reforms in Ukraine under the Fifth Round of Monitoring: The Istanbul Anti-Corruption Action Plan* (Paris: OECD) https://doi.org/10.1787/9e03ebb6-en.

Owen-Smith, J. and Powell, W. (2004) 'Knowledge networks as channels and conduits: the effects of spillovers in the Boston biotechnology community' *Organization Science*, 15: 5-21.

Perreira, A. (2023) 'The law of contingent control in venture capital' *Columbia Law Review*, 123: 675-727.

Pistor, K. (2019) *The Code of Capital: How the Law Creates Wealth and Inequality* (Princeton, NJ: Princeton UP).

Pollman, E. (2019) 'Startup governance'. *University of Pennsylvania Law Review*, 168: 155-221.

Pollman, E. (2020) 'Private company lies' *Georgetown Law Journal*, 109: 353-403.

Pollman, E. (2023) 'Startup failure' *Duke Law Journal*, 73: 327-386.

Pollman, E. (2024) 'Dynamic views of startup governance and failure' ILE Research Paper No. 24-25, Institute for Law and Economics, University of Pennsylvania.

Poteete, A., Janssen, M. and Ostrom, O. (2009) *Working Together: Collective Action, The Commons, and Multiple Methods in Practice* (Princeton, NJ: Princeton UP).

Rodrik, D., Subramanian, A. and Trebbi, F. (2004) 'Institutions rule: the primacy of institutions over geography and integration in economic development' *Journal of Economic Growth*, 9(2): 131-165.

Saxenian, A. (1994) *Regional Advantage: Culture and Competition in Silicon Valley and Route 128*. Cambridge, MA: Harvard UP.

Transparency International, Basel Institute of Governance (2024) 'Progress in Ukraine's Anti-Corruption and Judicial Reform Efforts' https://baselgovernance.org/sites/default/files/2024-06/240610%20Ukraine%20anticorruption%20update_digital.pdf

Wansley, M. (2019) 'Beach money exits' *Journal of Corporate Law*, 45: 151-202.

Appendix 1: WJP Rule of Law Index	
Factor	***Sub-Factors***
Factor 1: Constraints on Government Powers	1.1 Government powers are effectively limited by the legislature
	1.2 Government powers are effectively limited by the judiciary
	1.3 Government powers are effectively limited by independent auditing and review
	1.4 Government officials are sanctioned for misconduct
	1.5 Government powers are subject to non-governmental checks
	1.6 Transition of power is subject to the law
Factor 2: Absence of Corruption	2.1 Government officials in the executive branch do not use public office for private gain
	2.2 Government officials in the judicial branch do not use public office for private gain
	2.3 Government officials in the police and the military do not use public office for private gain
	2.4 Government officials in the legislative branch do not use public office for private gain
Factor 3: Open Government	3.1. Publicized laws and government data
	3.2 Right to information
	3.3 Civic participation
	3.4 Complaint mechanisms
Factor 4: Fundamental Rights	4.1 Equal treatment and absence of discrimination
	4.2 The right to life and security of the person is effectively guaranteed
	4.3 Due process of law and rights of the accused
	4.4 Freedom of opinion and expression is effectively guaranteed
	4.5 Freedom of belief and religion is effectively guaranteed
	4.6 Freedom from arbitrary interference with privacy is effectively guaranteed
	4.7 Freedom of assembly and association is effectively guaranteed
	4.8 Fundamental labour rights are effectively guaranteed
Factor 5: Order and Security	5.1 Crime is effectively controlled
	5.2 Civil conflict is effectively limited
	5.3 People do not resort to violence to redress personal grievances
	6.1 Government regulations are effectively enforced
	6.2 Government regulations are applied and enforced without improper influence
	6.3 Administrative proceedings are conducted without unreasonable delay
	6.4 Due process is respected in administrative proceedings

Factor 6: Regulatory Enforcement	6.5 The government does not expropriate without lawful process and adequate compensation
Factor 7: Civil Justice	7.1 People can access and afford civil justice
	7.2 Civil justice is free of discrimination
	7.3 Civil justice is free of corruption
	7.4 Civil justice is free of improper government influence
	7.5 Civil justice is not subject to unreasonable delay
	7.6. Civil justice is effectively enforced
	7.7 Alternative dispute resolution mechanisms are accessible, impartial, and effective
Factor 8: Criminal Justice	8.1 Criminal investigation system is effective
	8.2 Criminal adjudication system is timely and effective
	8.3 Correctional system is effective in reducing criminal behaviour
	8.4 Criminal system is impartial
	8.5 Criminal system is free of corruption
	8.6 Criminal system is free of improper government influence
	8.7. Due process of law and the rights of the accused