8

Venture Capital as a Commons

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8.1 INTRODUCTION

Venture capital should be a key case for the study of the corporation as a knowledge commons, given the significant degree of venture capital funding in certain economies (the US and the UK) and its growing extent in others (including mainland Europe, east Asia, and Latin America). Virtually all of the major corporations built out of the digital revolution began life as venture capital-funded startups or received venture capital funding at an early point in their evolution.

At first sight, however, venture capital does not look much like a commons. In a commons, norms for the governance of a shared resource emerge through a process of deliberation and experimentation between stakeholders; venture capital, by contrast, is characterised by bright-line rules which are precisely calibrated to manage risk. If the norms of the corporate commons are in part designed, and partly evolve, so as to ensure its sustainability over time, venture capital funding presupposes corporate failure as a highly likely, indeed on average the most probable outcome, resulting in the dissolution of the firm and reallocation of its assets, while the wider portfolio of firms making up a venture capital fund has a limited life of normally less than a decade. Where the legal structure of the corporate commons is one which acknowledges the contribution of employees and communities to knowledge creation and preservation, the legal structure of venture capital confers few if any voice and participation rights on these stakeholders, potentially exposing them to the costs of failure.

In this chapter, we take a closer look at the governance of venture capital (VC), at how it operates, and how it is legally structured. The basis of our analysis is recently completed interview-based fieldwork which focused on the European experience of VC and, specifically, on the prospects of developing a VC sector in Ukraine as part of its post-conflict reconstruction. This project provided us with the opportunity to explore the practical operation of VC through engagement with funds, startups, and their legal and financial advisers.

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We find that the legal structure of VC is indeed highly transactional, with clearly defined property and contract rights at the core of a widely used legal template, the aim of which is to allow investors to benefit in proportion to the gains made by successful firms, while limiting their exposure (financial risks) to those which fail. On the other hand, there are many elements of VC practice which resemble a commons. VC funds operate as pooling devices, enabling downstream risks to be shared across a portfolio of firms. Knowledge spillovers generate positive externalities beyond the gains captured by entrepreneurs, funds, and investors, thereby benefiting producers and communities. Formal legal rules, expressing individualised and indivisible property rights, are intertwined or "braided" with informal and relational norms. Insofar as VC succeeds in generating innovation, understood as the application of knowledge to novel technological ends, it is because these commons-type elements operate alongside and in conjunction with the hard-edged legal and financial ones. This is recognised, among others, by VC trade bodies, which increasingly emphasise a VC model directed towards "sustainable business growth," and which aim to deliver "economic and social value to those involved in the businesses (from employees, management and owners on the one hand, to customers and suppliers on the other) and a wide group of stakeholders (from local communities and local and regional economies, to national policy makers focused on issues such as climate change, diversity and inclusion and social justice)" (British Venture Capital Association 2023, 2).

Thus there is more to VC, and to the idea of VC as a commons, than immediately meets the eye. Yet the story of VC that we more usually hear is one of "disruption" and "destruction," however "necessary" and "creative" these are deemed to be. That there is a disjunction between the practice of VC and the way it is frequently presented poses a challenge for innovation policy. Legal exceptions designed to promote VC innovation may create perverse incentives, leading to value destruction, rent seeking, and negative knowledge externalities.

To develop these points, we begin by setting out some theoretical considerations concerning VC and the corporate commons, respectively. We focus here on Masahiko Aoki's theory of the corporation, which is one of the few accounts to address VC within a model of multi-stakeholder enterprise (Aoki 2010). Section 8.2 sets out a theoretical framework for understanding VC as a type of commons, building on Aoki's theory of VC as a particular form of *embedded cognition*. Extending the logic of the corporation as commons (Deakin 2012), the governance of VC becomes a question of maximising the net social return, taking account of both positive and negative knowledge spillovers, from VC-led innovation. In Section 8.3, we present our empirical findings. These focus on the contemporary experiences of Europe-based VC funds, startups, and advisers. Alongside features of VC that are familiar from the current literature, which tends to stress the elements of investor control and transactional flexibility characteristic of the US experience, we report on less familiar relational aspects of networks and systems in European

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VC. Section 8.4 brings together theory and evidence in an assessment of our findings, and Section 8.5 concludes the chapter.

8.2 VENTURE CAPITAL AND THE AOKIAN THEORY OF THE CORPORATION

The Aokian theory of the corporation contains the conceptual ingredients for a useful analysis of corporate knowledge commons, which can be seen as complementary to the Institutional Analysis and Development (IAD) framework (Ostrom and Hess 2007) and especially the Governing Knowledge Commons (GKC) framework (Frischmann et al. 2014). In this section we explore Aoki's distinctive understanding of the corporation as a form of embedded cognition, which can be extended to encompass a theory of corporate law as an endogenously generated, public representation of the enterprise form. We then apply the same theoretical understanding to the case of VC.

8.2.1 *The Corporation as Embedded Cognition*

In contrast to the theories of the "firm" associated with new institutional economics, Aoki presents a theory of the "corporation," of which the business firm is one instance. Aoki defines corporations as "voluntary, permanent associations of natural persons engaged in purposeful associative activities, having unique identity, and embodied in rule-based, self-governing organisations" (Aoki 2010, 4). All corporations, so defined, embed knowledge, in the specific sense, developed by Aoki, of *associational cognition*. Cognition is "associational" when it is distributed across and retained within networks of actors. The structure of the business firm, and ultimately its legal form, are determined by the way in which certain forms of knowledge become essential to the firm's operations. Relational *essentialities* between corporate actors explain the degree of control which is conferred by law and practice on different stakeholders.

In the large, bureaucratically organised corporation, the *cognitive assets* held by management are "essential" or core for the operation for the firm, while those of workers are only "quasi-essential." This explains, in Aoki's view, the hierarchical control which managers exercise in the organisation of production: the distribution of cognitive assets explains, in a functional sense, the organisational hierarchy of the firm. Shareholders, as monitors, are in a position to autonomously oversee and evaluate the evolving relationship between managerial and worker cognitive assets. Although Aoki observes the tendency for external monitoring of reciprocal essentialities through the capital market to become the norm around the world since the 1980s, he notes the risk that boards, under external investor pressure, will alter the balance of returns between shareholders and workers to the detriment of the latter, in such a way as to destroy value. German-style codetermination provides one possible solution, he suggests, by giving workers representation on boards, so

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enabling them to engage directly with shareholders in developing the firm's strategy. The Japanese "community firm" achieves a similar result less formally, via a series of social norms and institutionalised practices which balance shareholder rights with worker voice.

According to Aoki, VC emerges in contexts where the hierarchical organisation of the firm gives insufficient weight to worker cognitive assets which are essential to value creation. In his version of Silicon Valley's origin story, the decomposition of digital systems into modular units, connected by open interface rules, favoured the outsourcing of innovation to entrepreneurial startups. With the move to VC-based governance, startups provide the worker cognitive assets which are essential for innovation. Decentralisation of production to individual firms allows for a higher degree of specialisation than is possible within the integrated corporation while competition between firms drives improvements. The outsourcing of innovation favours an industrial structure based on complementary cognitive assets: through modularisation, "technological and attribute complementarities between products" are designed in such a way "that the cognitions involved in the design effort can be encapsulated without hierarchical ordering" (Aoki 2010, 45).

Venture capital funding, in which funds build portfolios of startup firms through which to channel investments, has particular properties in Aoki's framework. The managers of the fund, acting as *information brokers*, possess knowledge which is valuable but only "quasi-essential" in Aoki's terminology. The essential technical knowledge remains that of the entrepreneur and core employees of the startup. However, the value encapsulated in the startup can only be realised over time, as the project on which the firm is engaged plays out. Staged or "step finance" allows the fund to monitor the creation of knowledge essentialities over time. The role of the fund is therefore "akin to that of a referee governing a tournament game played among [startup] firms rather than managing them with its own essential cognitive assets" (Aoki 2010, 45).

This structure has implications for the way in which the fund manages uncertainty. In its role as the central monitor of a group of startups, the fund allocates investments between firms over the course of the startup life cycle in a manner akin to creating "option values" on their "parallel development efforts" (Aoki 2010, 46). The fund treats the individual firms as a series of "experiments," not all of which, or depending on circumstances, very few of which, need to succeed for the fund to make a return for its investors. However, "failed" firms, those which do not make it to a successful exit via an IPO or trade sale, may nonetheless generate ideas which will come to fruition at some point.

In this account, VC structures are highly decentralised, atomistic, and individualised, while at the same time operating through a *virtual corporate architecture* which is centralised, relational, and collective. Through its decentralised elements, the structure allows gains from innovation to be captured by successful entrepreneurs at the point of a trade sale or IPO once the investment has been realised, with

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stock options providing a means of rewarding the wider body of employees. The same structure, in its relational mode, generates a net surplus across the portfolio, in the form of returns to the investors as a group and to the managers of the fund, if the gains from the listing or trade sale of successful startups exceed the written-off investments in those that failed.

The VC structure also generates positive externalities beyond the individual fund. These take a number of forms: innovations developed by firms which fail, but which are then put to use in other projects; knowledge spillovers between projects, which are diffused via a mobile workforce; and tax revenues supporting public institutions, including universities and hospitals, which serve as knowledge repositories and training organisations. By these means, a wider *VC ecosystem* comes into being, with a corresponding set of cognitive assets which extends beyond individual firms (Aoki 2010, 44).

Returning to Aoki's definition of the corporation as a voluntary, rule-based, and self-organising association with a continuing existence, the implication of his analysis of is that attention should be focused on the network as a whole if the properties of VC are to be fully grasped. To the extent that VC ecosystem operates through the sharing of cognitive assets and resources, it is in need of a distinctive legal and transactional governance structure, one that is capable of supporting distributed coordination and generating a net knowledge surplus. How far does the current legal framework of VC meet these needs?

8.2.2 *The Cognitive Structure of Corporate Law*

Alongside his theory of the corporation, Aoki also offers an account of corporate law. In his approach, legal concepts specific to the corporation, such as separate personality and limited liability, operate as *public representations* of the emergent rules of corporate practice. Corporate law, in common with law in general, is an "endogenous normative order," which both reflects and frames the wider economic environment in which it operates. Law coordinates expectations by providing the parties with information on the rules of the game in which shared knowledge is codified. Thus law itself is an instrument of associational cognition, with evolutionary properties.

In reserving the term *corporation* for his description of the firm as an economic entity rather than a legal one, Aoki risks confusion. As Jean-Philippe Robé has argued, the economic concept of the "firm" and the legal notion of the "corporation" are two very different things. The "firm," in the sense used in new institutional economics, refers to a continuing entity or (the term Robé prefers) "activity" which combines physical and human assets in the production of goods and services (Robé 2011). The "corporation" is a legal term which refers to an artificially created person endowed by law with juridical capacity, that is, the power to enter into legal relations with other persons. Robé suggests using the term "firm" to refer to the economic

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entity and "corporation" to refer to the legal form. In practice, however, it is hard to maintain such a clear division, and Aoki's use of the term "corporation" in the economic sense is not in itself wrong, since lawyers do not have a monopoly in the use of terms (Deakin et al. 2017, 2021). Robé is nonetheless right to insist on the difference between economic and legal meanings of the term.

What, then, is the connection between the "corporation" as association, in Aoki's sense, and the "corporation" as the legal form which, as he puts it, "publicly represents" the association, or features of it? Aoki does not go into detail, but it would be consistent with his framework to suggest that the legal form is not a direct copy or replica of the economic one, nor a simple description of it. There is no one-to-one correspondence.

Rather, the legal form, as itself a type of *embedded cognition*, contains information which is functional with respect to the operation of the economic entity. Through the medium of legal language, features of corporate practice come to be recorded, abstracted, and retained for future use. As practice evolves, throwing up novel claims and form, juridical language adjusts to the changing corporate environment. The autonomy of the law implies that legal evolution is incremental and gradual, and that it may well be out of synch with fast moving technological and organisational changes. But over time, coevolution of law and the economy gives rise to a certain degree of "fit" between them.

The concept of the "corporation as commons" (Deakin 2012) is an application of the idea of law as embedded cognition. The claim is that there are features of corporate law which capture or represent an associational logic, present in the practice of corporations, which is akin to that of a commons. For this purpose, a commons is a shared resource governed by emergent rules whose function is to sustain the resource over time by reconciling the interests of the different groups that depend on and contribute to it (Hess 2008; Albareda and Sison 2020).

In Elinor Ostrom's typology (Ostrom 1990; Ostrom and Hess 2007; Poteete et al. 2010), commons-sustaining rules include norms of access, withdrawal, management, exclusion, and alienation. It is in the balance or tension between these different rules that the governance of the commons takes shape. Where multiple interests have the opportunity to participate in the making of the rules, the prospects for the survival of the commons as a shared resource are enhanced.

Thus like any other commons, the corporation or firm, understood as the continuing activity or entity through which production is organised, is a shared resource which benefits multiple interests, and is sustainable over time when each of these interests has a say in its governance. This is reflected in the logic of the corporation in its legal sense, as the form through which enterprise is cognised and regulated through law. The totality of the firm cannot be owned by any single group (Robé 2011), including the shareholders, who have no direct access to the corporate assets, and do not contract directly with the suppliers of other inputs. Vesting the ownership of the firm's working capital in the juridical person, the corporation, which cannot

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itself be owned, is not a legal "fiction" or sleight of hand, but a functional device for capturing the associational dimension of corporate practice. In the same way that the Aokian corporation is an emergent totality which is greater than the sum of its parts, so a holistic view is needed to comprehend the legal structure of the firm in all its relevant aspects, which extend beyond the core of company law to embrace elements of insolvency, employment, tax, and competition law.

Granting that the idea of the corporation as commons has a certain traction in the context of the integrated business firm, can the commons concept also be applied to the context of VC? Adopting Aoki's position, the equivalent of the integrated firm in the VC context is not the single startup, but the virtual corporate architecture linking funds to investors on the one hand and startup firms on the other. The fund-managed VC portfolio is linked to other elements of a wider VC ecosystem which includes service providers such as specialist law and consulting firms and public research institutions. The social value of the ecosystem is not confined to the returns achieved by investors, or for that matter other participants in the VC funding cycle, including fund managers, founders, and employees. Aoki's account of VC emphasises that the system-wide benefits can accrue to the professional firms which service VC and the universities and (in the case of biotech) hospitals which combine basic research with the provision of public health and education goods.

Thus, a VC ecosystem, as a *type* of commons, may be said to be sustainable when it generates a net social surplus, taking into account not just financial returns but also the knowledge spillovers and other positive externalities generated by the system as a whole. Venture capital does not just generate positive externalities, however. Over-ambitious and fad-driven projects, inflated firm values, stock market bubbles, and corporate fraud are also features of VC, and can be traced to the same legal structures which support VC-led innovation (Pollman 2020).

8.2.3 *The Legal Framework of VC*

Venture capital financing is legally structured according to a template which was initially established in the US and has come to be regarded as an industry standard which other countries should seek to emulate or replicate. The key features of the legal template are generally interpreted as reflecting a principal–agent logic. In this approach, innovation is characterised by a high-risk, high-return dynamic. Startups begin as micro enterprises with few or no physical assets and so have no collateral of the type needed to raise credit. Under these circumstances, investors are willing to finance startups only if they can protect themselves against downside risks. Investors manage risk by delegating control to the fund managers, who leverage their knowledge and experience in selecting firms for funding and, when necessary, deselecting a certain proportion of them as the funding cycle proceeds. Staged financing gives the fund the power to exercise close control over the firms in the portfolio and the opportunity to exit if a project looks like failing.

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A key legal feature of VC finance is convertibility, that is to say, the power of the fund to switch the legal form of its investment from debt to equity and back again at points in the VC funding cycle. The practice, originating in the US, 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 (Kaplan and Strömberg 2003). 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. More recently, instruments akin to convertible loans, such as the SAFE (secure agreement for future equity) or KISS (keep it simple security), have become widely used. Reflecting a wider trend in corporate finance (Lalafaryan 2023), these instruments blur the line between debt and equity.

When the fund converts preferred stock or a loan, as the case may be, into common stock if the startup succeeds, it is in a position to benefit in direct proportion to the firm's success through an IPO or trade sale. If, on the other hand, the project fails, the fund is in a better position, as a preferred shareholder or lender, to protect itself against downside losses, than it would be if it held an equivalent common equity stake. Enabling the fund to flip its interest from debt to equity in this way can be defended as a precondition of startups with limited assets or earnings getting access to capital. The same arrangement, however, enables the fund to offload risk on to other input providers.

Another feature of the legal structuring of VC is that funds can exercise close control by taking seats on the board of the startup, or by stipulating for observer rights. It is also common for shareholders' agreements, supplementing the terms of corporate charters (articles of association or bylaws), to grant funds veto rights over certain transactions and to prevent the dilution of their holdings downstream as other investors take equity stakes.

Several theories have been offered to explain the role of the IPO in structuring incentives. 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 essential knowledge on the part of acquiring firm.

Exit dynamics are not all positive. The so-called VC power law dictates a strategy for funds of seeking exponentially high returns from the small number of successful

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startups, to compensate for losses in the majority of the portfolio. However, 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 or trade sale stage. Founders may try to exit before the firm realises its full investment potential. Funds respond by using their veto powers to prevent "beach money exits," which are of 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 which they and the 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. A seven year or similar term is normal, but 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. Conflicts occur not just between funds and founders but also 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. This has led some 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).

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If the distinctive transactional structure of VC is largely the result of private ordering, VC is also defined by certain trends in regulation. Investments in VC funds enjoy various tax reliefs, depending on the jurisdiction in question. Share options, widely used to remunerate employees in high-tech startups, often enjoy a similarly beneficial tax treatment. In order to minimise their labour law obligations, startups often characterise employees as independent contractors, a practice which courts may be prepared to condone and which legislation in some jurisdictions actively encourages.

Employment law plays a role in framing VC, 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 it does seem 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 2005). A lenient bankruptcy law, which avoids unduly penalising entrepreneurial failure, is another factor often cited to explain Silicon Valley's success (Armour 2002).

It is not entirely clear how far close adherence to the original US template is a precondition of attempts to build VC ecosystems elsewhere. The UK, which has had a sizable VC sector since the 1980s, if one that is still much smaller than its US equivalent, has a legal framework which is similar to that in the US, but also 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. 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. In a marked contrast to California, English courts regularly enforce employment non-competes in the form of restrictive covenants and garden leave clauses.

Certain features of the US VC model can only with difficulty be transplanted into the civil law systems of mainland Europe. The conversion of preferred to common stock is not as straightforward as it is in the US, and 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). Substitutes for conversion may replicate some of its effects. In Italy, non-convertible participating preferred shares are used to give VC funds priority over other investors, and there are mechanisms for converting debt to equity. Co-sale mechanisms can also be observed. US-style

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"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 2023).

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 event (Lin 2020; Giudici et al. 2023). However, 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).

Insofar as legal regimes outside the US are unable to replicate aspects of the standard VC template, startups can access US structures by taking advantage of the rules of the conflict of laws, which allow firms to designate a foreign legal system as 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 jurisdiction, which becomes then its corporate law "host," while remaining subject to tax and employment laws in the former jurisdiction.

In short, the law is imbricated with the operation of VC systems at all levels and stages of their operation. The distinctive legal template associated with US VC is believed to have been a causal factor in the success of Silicon Valley (Armour and Cumming 2006), to the extent that other countries have sought to emulate it, with varying degrees of success (Enriques and Nigro 2023), and startups based outside the US increasingly seek to access it, by taking advantage of flexible incorporation and listing rules (Clarysse et al. 2009). Yet the "contingent control" and "power law" dynamics which flow from the US template are also at the source of growing horizontal conflicts, leading to value destruction and negative knowledge spillovers,

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in the US context where they have reached their most advanced form (Pollman 2020, 2024). While it was until recently taken for granted that European VC should be seeking to replicate the US model, this is no longer so clearly the case.

8.3 EUROPEAN VC IN PRACTICE: EVIDENCE FROM A QUALITATIVE STUDY

Recognising venture capital as a commons-like structure clarifies the need for governance models that do not only institutionalise control over capital but also organise the associational cognition on which the success of the wider VC ecosystem depends. In understanding how venture capital operates in practice as a commons, it is helpful to focus on the European context, where institutional design varies but increasingly reflects an ecosystem-based approach which departs in significant respects from US practice.

8.3.1 *Scope of Study*

The initial focus of our empirical research was the potential role of venture capital in supporting Ukraine's post-conflict reconstruction. 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. Ukraine's government has taken a number of steps to encourage VC-based innovation, including the creation in 2022 of "Diia City," a legal "free zone" intended to support IT-related startups. Entities opting into the Diia City legal regime benefit from an advantageous tax regime and can take advantage of a template customised for VC which includes convertible loan notes, option agreements, and standard-form representations and warranties.

With a view to understanding potential legal support for, and obstacles to, VC development in Ukraine, we conducted twenty-five interviews 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. By these means we were able to obtain an insight into the current state of European VC.

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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 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).

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 a problem 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. 2010).

A qualitative approach may be needed for understanding 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 (Jennejohn 2008; Gilson et al. 2009, 2020, 2011). 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

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contractual devices (Giuidici et al. 2022, 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 at least inaccessible from outside the sector.

We begin by examining a number of issues of general interest for understanding the operation of VC in its European (including Ukrainian) context: the relational dimension of the control exercised by funds, the blurring of equity and debt, approaches to exit, and the management of less successful firms. We then consider the issue of system-wide effects, and address the question of how far the limitation of the legal environment for VC in Europe can be overcome through a US incorporation or is a strategy of creating legal exceptions for VC within domestic law, as in Ukraine's Diia City model.

8.3.2 "VERY MUCH NOT ABOUT CONTROL": RELATIONAL MONITORING AND OVERSIGHT

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 arm's 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 than majority stakes 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).

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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 liquidation 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 liquidation 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

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> 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)

8.3.3 *Debt and Equity: "Don't Over-complicate It"*

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 initial seed stage 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 to 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 [early stage] 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.

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8.3.4 *Exit Dynamics: "Control the Downside"*

Exit via an IPO might be an ideal for funds and startups alike, 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. Conditions at the time of the interviews (2023–24) 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; they would more likely 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 if 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. 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 [as the fund was relatively new] 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)

Achieving a portfolio-wide return from just one or two investments 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

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> 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 [investment] 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 out 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 on the downside, control the downside risk. (Lawyer, UK)

8.3.5 *Managing Less Successful Firms: "Ticking Over"*

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 its 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).

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8.3.6 *Employment Law: "Who Wants to be a Bad Leaver?"*

European labour law systems offer varying levels of flexibility 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. However, very few of them observe the US employment at will rule, under which the default position is that the employer has the right to terminate the employment contract on no or minimal notice, without needing to show a reason for doing so. The relative inflexibility of employment laws in some mainland European jurisdictions, including France, Germany, and Italy, was cited by some of our interviewees as a reason for the limited growth of VC in those systems. However, none of our interviewees was prepared to accept the quid pro quo of US employment at will, namely the ban on non-competes which operates in California and which the US Federal Trade Commission was at the time of the interviews attempting to regulate out of existence on the grounds of its anti-competitive effects.

On the contrary, European funds 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 penalise 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).

In addition, European-based startups have several options available to them if they want to avoid the application of the general labour laws. Several countries allow de facto exemptions from labour laws by permitting IT workers to incorporate as micro enterprises, or to make use of civil contracts for services. These arrangements

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generally attract a lower rate of income tax. However, interviewees also cited the downside of using contractors whose knowledge and skills were essential to the firm:

> 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 any case the employer must have the control right, so then you may end up paying the tax anyway. (Startup, Ukraine).

Using workarounds was seen as potentially problematic from the point of view building 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)

In short, using contractors and workarounds could often be insufficiently protective of the *employer* interest.

8.3.7 *Ecosystem-Wide Effects: "Essential for an Onshore Industry"*

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 a 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 through alumni help and networking, adding to the credibility of startups: "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 [British Venture Capital Association] 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:

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> Having a suitable vehicle is essential for an onshore industry. . . . 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 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 was thought to be important over time 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," European countries with developing VC sectors 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). There was some scepticism concerning the suitability for Ukraine 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" (Entrepreneur, Ukraine).

Questions were also raised over the strategy of creating a legal enclave, within which the standard VC template could be accessed and common law approaches to transactional flexibility applied. The Ukrainian Diia City regime was seen as offering advantages in terms of legal flexibility by some of the Ukraine-based funds we interviewed. However, there were other views: "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 to the process of building trust in local institutions and processes:

> 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)

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8.4 ASSESSMENT

Our interviews suggest that 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 entrepreneurs, investors, and advisers, assisting reputation-based enforcement, and the generation of trust at ecosystem level. In practice, the VC fund startup has to be at least partly relational, rather than exclusively control-orientated if it is to work. As debt and equity become increasingly interchangeable, the relationality of debt-based forms of governance are coming to the fore. While exit dynamics in Europe reflect the need to obtain high returns from a small minority of firms as they do in the US, the power law is tempered in the European context, with less extreme outcomes at either end of the distribution, and greater tolerance for investments that do well enough to survive without generating hyper-profitable outcomes. European VC funds are willing to support lifestyle companies and arrange exits via acqui-hires, alongside more spectacular successes. In the conditions of a market downturn, which prevailed when we conducted our interviews, IPOs are rare compared to the 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.

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. Although it is believed that misalignment of European corporate law regimes with the US template puts European VC at a disadvantage (Enriques and Nigro 2023), 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 the US-origin SAFE and KISS.

With respect to employment law, few European labour law systems come close to the flexibility of the US contract at will model. On the other hand, non-competes are more straightforwardly enforceable in the European context, and funds are not slow to use them to protect their interests. Using contractors in place of a directly employed workforce is not always straightforward from the point of view of additional transaction costs and a potential loss of access to essential knowledge.

Insofar as European legal systems nevertheless remain out of line with VC needs, the gap may be filled by reliance on access to the US legal system and to a lesser extent English law, to supply the basic VC template. Many European startups are either incorporated in US or English law or operate through a US or English-law holding company. Thus, in common with startups in other European countries, startups in Ukraine are in a position to take advantage of the transactional flexibility

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of US corporate and commercial contract law. Use of foreign law for corporate and commercial transactions may offer a plausible route for the development of European VC in the short term, but its positive effects may be time limited. The same point applies to legal "free zones" such as Ukraine's Diia City. Overreliance on foreign law and legal carve-outs runs the risk of missing out on the wider ecosystem benefits of VC, as knowledge-essential legal and financial skills remain offshore.

8.5 CONCLUSION

Venture capital seems at first sight to be an unpromising case study for the hypothesis of the corporate knowledge commons. The portfolio structure of the VC tournament pits startup firms against each other in a race that only a few can win. Exponential returns for the occasional successes balance losses in the vast majority that fail. Staged financing allows funds to dictate terms to startups and to decide the form and timing of their exit. Underlying the VC "power law" is a legal structure decisively tilted towards the interests of investors, who can flip their interests from debt to equity and back again to maximise their returns from successful projects while minimising their losses from failures. This hyper-flexible structure can leave other stakeholders out in the cold. Founder-entrepreneurs may be in a position, by virtue of their shareholdings, to benefit on the upside, and share option schemes enable employees to do likewise, at the cost of a loss of control over the form and timing of exits, and exposure to downside risks. The standard legal template for VC, once regarded as a causal factor in the success of the US model and a precondition for its dissemination to other countries, is increasingly seen as generating perverse incentives, which are reflected in rent-seeking (costly litigation) and value destruction (high-profile frauds).

If, however, the US-origin legal template is coming under question, this is arguably because it is at odds with features of VC practice which more closely resemble a commons than is generally supposed. As Aoki's model of VC emphasises, knowledge essentialities are tied up within startup firms; the knowledge possessed by the fund is only quasi-essential. Thus funds have to temper their control rights in ways which acknowledge the interests of founders and employees. Our interviews show how formal legal rights are "braided" with the practice of relational monitoring in order for individual projects to be brought to fruition and wider knowledge spillovers generated. In European VC, the search for exponential returns goes on, but there tends to be a more supportive attitude towards portfolio firms which are sustainable without being hyper-successful. Treating employees as a disposable resource while seeking to control their mobility through non-competes, an option unavailable in the US, is a hazardous strategy in a context where the workforce represents the firm's core cognitive asset.

In the final analysis, VC is no less a commons, dependent on the input of multiple stakeholders and on their shared participation in the emergent rules of the game,

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than other corporate settings. Venture capital relies heavily on the spillovers created by various ecosystem players, including locally based venture firms, trade associations, angel investors, legal advisors, startup networks, and informal mentors. Informal, culturally rooted elements significantly impact the performance of European VC ecosystems. However, they are frequently underrepresented in formal legal frameworks, particularly those originating in or borrowed from US practice.

An excessive emphasis on investor control and the formal properties of bright-line legal rules is currently putting the much-vaunted VC model into question in its system of origin, the US. The divergence of European VC from the original US form may be not so much a cause for concern, as the occasion for reflection on the persistence of diversity in corporate law and governance.

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