Babeș-Bolyai University
Faculty of Law

DOCTORATE THESIS

Legal analysis of financing startup enterprises

- SUMMARY -

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I. THESIS CONTENT

II. ASPECTS REGARDING THE FUNDAMENTAL RESEARCH

The research tools used cover both the doctrine, usage and case-law in the jurisdictions mentioned above as well as the imperative or soft-law rules. The doctrine opinions come mainly from the US and the UK, where alternative business funding is used for a longer period, with a very high volume and which are holders of the status of pioneers in the field. Taking into consideration the current development of the innovative entrepreneurial phenomenon and the exponential development of some European businesses, the field of these financings has also been addressed increasingly by continental doctrine. Thus, we have analyzed in this paper, in particular, those articles from specialized journals from the aforementioned jurisdictions. When it comes to the national sources, they are almost completely absent from the doctrine, with research focusing on analysing the traditional institutions.

The objective of this paper is to provide a legal perspective of modern financing of entrepreneurial businesses, having in mind that they make their presence progressively felt in the national business environment. In this respect, this study can contribute both to the contextual legal and cultural adaptation of phenomenon imported from different jurisdictions and to the identification of the needs to adapt traditional societal institutions to the current context of the business environment. At the same time, we do hope that this approach will be an impetus for theorists of law to approach the subject in their future researches.

The novelty of this paper is based on the architecture of the approach to the subject of the company's financing. If certain legal institutions, usually considered traditional, have been the subject of previous studies, the uniqueness of the thesis lies our approach towards those institutions, in a specific context, and characterized by modern attributes, namely that of innovative startups. If, in the context of *in bonis* financing companies, certain legal instruments have shown their value both in practical terms and through the doctrinal interest, the phenomenon of entrepreneurial financing, in the context of the digital age, subjects these approaches to new perspectives. Furthermore, the analysis of the effects of the investment phenomenon addressed in the plan of corporate governance is a novelty in the national doctrine, and the specificity of national societal forms brings to the approach the new attributes in the international context.

III. CONTENT OF THE THESIS

The paper addresses the legal perspective of the phenomenon of modern entrepreneurial financing, strongly influenced by the model of new businesses, especially those in the field of technology, which achieve unprecedented performances. The exponential growth of such a business can only be sustained by large capital injections in short periods of time. The main obstacle, however, is the high risks of failure, overlayed with or sometimes determined by the closed nature of private companies. The opacity of publicly available information about such a company and the specific way of functioning emphasises the problem of the risks that the investors assume. In this regard, in jurisdictions experienced in such requirements, certain specific practices have developed, and in some cases those practices were confirmed by legislative regulations, regarding the conduct of transactions and the use of certain legal and financial instruments that meet, to the greatest extent, the needs of the actors involved. The structure of the thesis concerns the legal perspective of the entire ecosystem of entrepreneurial financing which can only be understood from an overall perspective.

The novelty of the subject, both from a doctrinal point of view and in the approach of the phenomenon at national level, has imposed an approach that presents entrepreneurial financing as a whole. By reading this study the reader can acknowledge an understanding of how startup-specific financing works, as well as specific legal details and personal opinions on how they need to be addressed in the context of domestic law. Similarly, on a one-off basis, the thesis presents the views, critics or possible solutions, proposed by the author, for adapting the regulations to the real and current situation of the economic and business environment.

In the first chapter of the thesis, dedicated to the perspectives on financing and dynamics of the capital structure of startups, the study presents the way in which the company finances its current operations at the various stages of evolution and the correct identification of the form of financing specific to their maturity level. In this respect, the structure of the research concerns all the evolutionary stages of the startups and the characteristics of the business operations related to their evolution. In this section, in addition to analysing the general context of entrepreneurial financing and presenting available sources, the essential feature of investment in innovative businesses, specifically development-stage financing and funding rounds, is also addressed. The

thesis takes into consideration the influence of cutting-edge technologies such as blockchain and artificial intelligence on entrepreneurial financing, such as virtual currencies and public cryptocurrency offerings. We believe that, although still at an early stage as means of financing, these new technologies have the power to influence the entrepreneurial ecosystem in a disruptive manner. Although the first initiatives of decentralised autonomous systems have failed, new such attempts will challenge the legal environment that will be confronted with new legal perspectives and relationships influenced in an ever-growing manner by robots.

The final section of this chapter concerns the context of the liquidation of investments by the financiers in order to mark the yield pursued. As financiers aim to make a profit within specified periods of time, scheduling the exit from the financed companies becomes a priority. In this regard, strategic sales, share buyback, secondary sales or listing on the capital market have become recurring transactions in entrepreneurial businesses. Although listing a company on a capital market is a mean of financing the company, from the perspective of investors in entrepreneurial businesses it is seen as a way of winding up the investment and thus marking the desired profit.

The second chapter of the thesis is dedicated to the analysis of legal instruments specific to transactions concluded between the financed and the financier. The complex nature of financing agreements (in particular those arising from venture capital funds) is due to the requirements imposed by investors to ensure a certain degree of control of the financed business. The motivation behind such an investment approach is given by the intention to mitigate the risks of the investment, the possible intervention in the event of the diversion of interests and, last but not least, to ensure control over the timing and manner of liquidation of the participation in those companies. All these requirements involve either the use of specific legal instruments or 'common' commercial law institutions adapted to specific relations. Since import jurisdictions have developed these instruments in accordance with the specificity of the legal system of provenance, their adaptation to the context of national law presents some difficulties, which are the subject of the analysis. Taking over international usages without local adaptation does not entail similar legal effects and, moreover, may be at odds with already existent national regulations. In this respect, we propose a local perspective and interpretation of the legal institutions which today have become constant in the documents and procedures carried out in entrepreneurial financing transactions.

The punctual analysis of the usual legal instruments used in financing transactions shows that the effects of using such processes are not those which, at first glance, would seem natural. One of the constants that has arisen regarding this subject is the impossibility of enforcing the clauses used in the extra-statutory pacts in the manner in which they would be desirable to have their effects. For this type of clauses that are impossible to be enforced, such as the example of any conventions on General Meeting voting, damages remain the remedy for non-execution. The practical finding is that those conventions do not consistently use the institution of the penalty clause, which is why we do consider that any dispute between the partners (founders and investors) will have an unpredictable outcome, since a quantification of direct and indirect damage is difficult to achieve. The justification offered by investors (those who propose and impose these usages) for the use in continental systems of specific common law institutions and US company law is given by the fact that the aim pursued by most venture capital funds is to relocate companies from their portfolio, especially in US jurisdictions, once a certain degree of development and/or financnig has been achieved. This fact also points out from existing statistics, statements by investor representatives and public information available in the media. With this motivation, in countries such as Romania, financiers request the use of current practices in the locations where the financed entities are to be conducted.

The third chapter addresses the first specific source of financing, which is exhaustively analysed, i.e. individual business angels investors. Although individual investments in entrepreneurial business have a long history, recent decades have brought a new perspective to these sources of financing. Various jurisdictions have adopted specific rules applicable to these investments, in particular aiming to encourage the intervention of individuals with financial resources and experience in the entrepreneurial environment (by granting tax advantages). The massive development of these investments has led to an evolution of proceedings and an increase in the complexity of transactions between business angels and beneficiaries resulting in the incresed legal risks and problems. The collaboration between this type of investors and the growing needs for access to information (with an implicit increase in costs), relative to the large volumes of funding requested by entrepreneurs, has led to the emergence of business angel investor groups, local unionization of the phenomenon and a different approach to the characteristics of investments initiated by venture capital funds. The evolution of individual investments in this respect has undoubtedly led to the need for a pronounced legal approach to the phenomenon, which is the

reason why in this study we have offered both the international and national legal perspectives on this type of investments. While they may be considered privileged from a legislative point of view, as they benefit from specific legislation to encourage individual investment initiatives, following the extended analysis, it appears to be almost ineffective in its entirety and certainly without the effects expected by its initiators. The criticisms of the regulation concerns its very foundation, the aspects covered by the rule of law demonstrating that it is not in line with the main characteristics of the concerned financings. We believe that, in order to properly encourage business angels investments, in addition to general measures aimed at developing the entrepreneurial environment, measures must be taken in order to encourage both parties involved in these transactions, namely financiers and beneficiary companies.

Participatory financing or crowdfunding, as a method of entrepreneurial financing, is addressed in Chapter IV of the thesis. Obtaining financial resources from the "crowd" has undergone exponential growth with the development of the Internet and social media. These tools have made it easy to connect financing applicants with individuals willing to provide the financing through online crowdfunding platforms. The easiness to access such investments, both from the perspective of beneficiaries and individual financiers, raises serious legal questions related to their relationship, the relationship between them and platform holders and, last but not least, the need for legal protection for inexperienced investors in relation to the (sometimes) high risks of the investments. In order to cover such needs, different jurisdictions have considered useful regulating this area and have acted promptly in this regard, but it is of particular interest the special European regulation on crowdfunding platforms, which will be enforced at the end of 2021. As the European perspective will become mandatory for the Member States through the direct application of the new regulation, it is directly of interest to local service providers, but we consider that the effects of the regulation will affect the whole phenomenon of participatory financing in Romania. The intention of the European legislator is to create an European multi-financing market by encouraging cross-border investment of this type. Although it is very welcomed as an initiative, the mere reading of the Regulation leads to the idea of rigid regulations, with many references to complex European capital market regulations and rules. We wonder, therefore, whether a rigid and thorough approach does not lead to the idea of over-regulation, with undesirable effects in the context of the stated aim, namely, to encourage the phenomenon of entrepreneurial financing. The strictness imposed on service providers may have the effect of transposing too high standards on

the possible financing projects. The similarity of the operating principles with those imposed in the context of capital markets will assimilate the platforms of some market operators. Although in such a context investor protection is genuinely desired, there is a risk of an adverse effect of restricting the number of startups eligible because of any additional conditions to be imposed by the owners of the platforms authorised in accordance to the aforementioned regulation.

Chapter V of the thesis covers entrepreneurial financing through venture capital funds. This type of investments is made from the institutional resources of various entities, such as pension funds, banks or insurance companies through professional managers. The latter, as intermediaries, are the ones who coordinate the work of the whole fund, having control over the money of the financiers for limited periods of time in which they aim to achieve high returns. Financing is conducted in exchange of equity to financed companies, but for the stated purpose of liquidating that participation after a certain period of time in which the business has grown exponentially, and the participation can be redeemed at a much higher valuation than at the time of the investment. These investors are the ones who bring the highest sums into entrepreneurial entities, but they also assume the highest risks. In this regard, investment procedures are also extremely complex, with fund managers and professional investors, who are also imposing strict conditions for the conclusion of transactions. The presence of risk capitalists and the existence of such investments in Romania are at an early stage, and the construction of a market based on a solid foundation requires the understanding and use of right legal institutions adapted to the local environment. For this reason, the structure of the chapter addresses the topic in the aforementioned manner.

The theme of Chapter VI of the thesis presents the consequences of new investment phenomenon on the structure of the company and the architecture of corporate law. In this respect, we have identified, first of all, the specific effects on the governance of business entities and the differences from the traditional functioning of standard companies. The modern legal relationships resulting from financing transactions lead to tensions and conflicts that do not exist in classical structures and hierarchies, which require appropriate solutions. Thus, the different attributes granted to the financiers according to the financing rounds and the time of entry into the company, as well as the use of the different participation mechanism, create more conflicts in the vertical plan and in the horizontal plan of the company structure. Interests may diverge according to the purpose of each category of stakeholders, some of whom are interested in immediate liquidations

of their participations, others in medium terms or even retention of their securities. In the same manner, the company administration, holding their own equity securities, will pursue the interests of the group to which it belongs or to the group which directly appointed certain members in the board (see the recurring practice of agreements whereby venture capital investors negotiate their right to appoint one or more board members). Thus, we do consider that there is a certain need to outline principles of governance, which must reduce the risk of conflicts as those mentioned above.

Taking into consideration the work of the administrative bodies, the position of the investor-appointed member in the board of directors appears to be nuanced. The purpose of negotiating such a position in the structure of the company is to ensure an effective control and to obtain valuable information, to ensure the investment and to increase the chances of controlling the achievement of a performing return by rapidly liquidating their participation when the right moment arrives. If at first glance the action and its effect appear to be justified, we consider that such a procedure raises some questions of corporate law. In this respect, the institution put to the test shall be that of the fiduciary duties owed by the directly appointed member. Although we can easily interpret the position of the director as that of a direct trustee of a nominal shareholder (or a group of shareholders), corporate law does not allow such a perspective. In the context of both national law and other international jurisdictions, the current rules do not derogate from the general principle established for such obligations. Thus, the creditor of the obligation of the directly appointed director remains to be the company itself and not the shareholder who appointed him. In such a case, the situation becomes sensitive taking into consideration the potential conflicts of interest that might appear between the director and the company and the real possibility of fulfilling the existent fiduciary obligations.

From the same point of view, that of company law, we have ascertained the difficulty of adapting the legal forms existent in continental law systems with the norms and practices imported from common law jurisdictions, in particular, those imported from USA. Contractual freedom, as an attribute of the mechanisms used in the context of entrepreneurial business in these jurisdictions, is confronted with the rigidity and over-regulation of European law, which complicates the import of constant processes in the field. The current national regulations qualify the SRL as the legal form chosen almost unanimously by entrepreneurs for the incorporation of the economic business they develop. Being a mixt company, found at the congruence of the characteristics of capital

entities and person entities, fundamentally, SRL was not designed to receive external equity. The private company characteristics and attributes such as trust between associates, *affecto societatis*, the limited number of associates or the rigid manner of forming the corporate will involves the use of conventional legal artifices, which cannot adequately fulfill the requirements of the parties involved. We consider that in the context of modern businesses, corporate law and, in particular, the already regulated legal forms need to be reassessed. The latest trends of modification of the SRL in Romania seem to renounce the rigidity mentioned above and to delimit themselves from the characteristic of the close relations between the associates. Although at least some of these aspects affect this type of business (see the possibility of free transfer of shares, if the articles of association derogates from the alternative rule of necessity of the General Meeting of Shareholders agreement), they do not have the capability to solve the discrepancies imposed by the modern way of entrepreneurial financing. Other available possibilities to the legislator to move towards solving those problems consist either in a reform of the current SRL or in the development of a new legal associative form, as a special vehicle for entrepreneurial businesses with high development potential and aimed at obtaining external financing through capital investments. Italy is the reference jurisdiction which has chosen to change the equivalent of SRL in Romanian law, with the stated aim of developing a form of society that meets these needs.

Platforms, both as business activities and as new organizational structures of the company, lead to new legal perspectives on companies. The relationships between platform owners, developers and consumers have characteristics, accentuated by the fact that the whole process is conducted online. From a company law point of view, the governance of those platform entities alters the relations between holders of interests, balancing their powers, with the consequence of the emergence of a so-called flattening hierarchy.

The architecture of the thesis is shaped around an entire system, addressing in the first chapters the general aspects of entrepreneurial investment, then, addressing the actual ways of financing, followed by their effects on business entities. The final part of the study presents a new perspective on the future of entrepreneurial business and of the corporate law, in the inevitable context of technology and digitalisation.

IV. KEY-WORDS

startup, financing, entrepreneurship, legal instruments, busines angel investor, multifinancing, venturie capital funds, corporate governance, legal form.