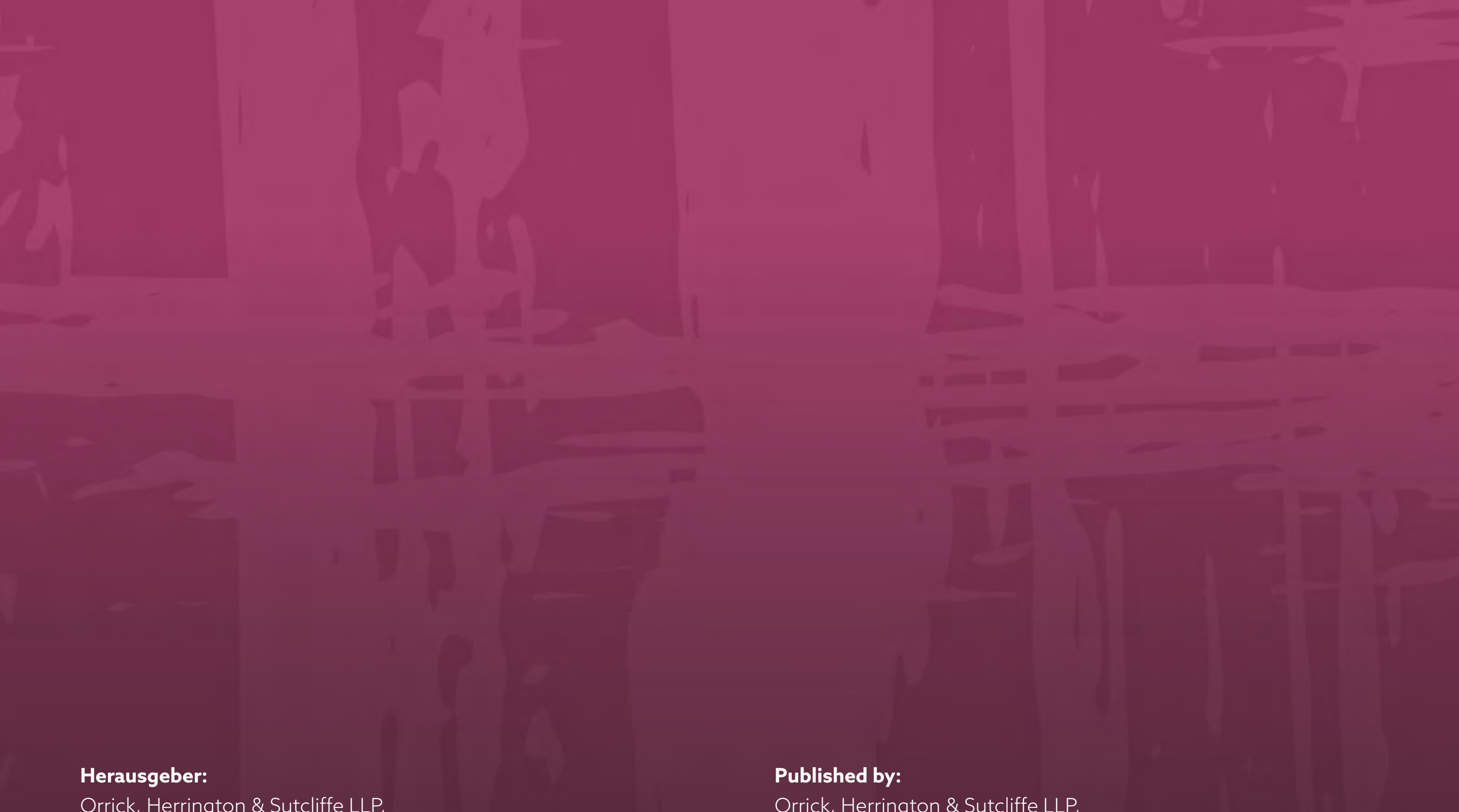
VENTURE CAPITAL DEALS IN GERMANY

PITFALLS, KEY TERMS AND SUCCESS FACTORS FOUNDERS NEED TO KNOW

VC & TECH BRIEFINGS GERMANY



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Die Orrick Legal Ninja Series – OLNS

Mit unseren auf Technologietransaktionen spezialisierten Teams in allen wichtigen globalen Märkten begleiten wir zahlreiche deutsche Tech-Unternehmen auf ihrem Wachstumspfad. Als eine der führenden Tech-Kanzleien weltweit fühlen wir uns darüber hinaus verpflichtet, die Gründerszenen in den USA und Deutschland noch stärker zu vernetzen.

Aus diesem Grund haben wir die Orrick Legal Ninja Series (OLNS) ins Leben gerufen. Mit dieser periodisch erscheinenden Serie wollen wir Überblicke zu aktuellen rechtlichen Entwicklungen geben, aber auch vertieft Themen aufgreifen, die für Start-ups und ihre Investoren besonders wichtig sind.

Hinter OLNS steht ein multidisziplinäres Team aus unseren weltweit mehr als 25 Büros. Dieses hat es sich zur Aufgabe gemacht, unseren internationalen Erfahrungsschatz in den Bereichen Venture Capital, Corporate Venture Capital und Technologietransaktionen für diejenigen nutzbar zu machen, die in Deutschland Venture und Innovation unternehmerisch nach vorne bringen.

Woher das "Ninja" im Namen kommt? Vielleicht weil einige von uns in den Neunziger Jahren einfach sehr viel Fernsehen geschaut haben… Im Ernst, ein "Ninja" ist gerade im angelsächsischen Sprachraum zum Synonym geworden für "jemand(en), der sich in einer bestimmten Fähigkeit oder Aktivität hervortut". Das ist unser Anspruch, wenn wir junge Technologieunternehmen und ihre Investoren maßgeschneidert beraten. Wir hoffen, dass OLNS Ihnen dabei hilft, "Ninja Entrepreneurs" zu sein.

Wenn Sie Anregungen haben, nehmen Sie bitte Kontakt mit uns auf, Ihre Erfahrungen interessieren uns sehr. Wir wollen uns kontinuierlich weiterentwickeln, um unsere Mandanten bestmöglich begleiten zu können.

Wir hoffen, dass Ihnen die vorliegende neunte Ausgabe unserer OLNS gefällt.

Im Namen des Orrick-Teams

Sven Greulich

Orrick — Technology Companies Group Deutschland

About the Orrick Legal Ninja Series – OLNS

In substantially all the major world markets, we have dedicated technology lawyers who support young German technology companies on their growth trajectory through all stages. As one of the top tech law firms in the world, we are particularly committed to bringing the American and German entrepreneurship ecosystems closer together.

For this purpose, we have launched the Orrick Legal Ninja Series (OLNS). With this series, we will provide overviews on current legal trends and take deeper dives on certain legal topics particularly relevant for start-ups and their investors. This series will be co-authored by a multidisciplinary team of lawyers from our national and international offices. It is our goal to tap into the rich reservoir of the venture capital, corporate venture capital and technology know-how of our international platform and make it available to the exciting German entrepreneurship and innovation scene.

Why "Ninja Series?" This title might simply reflect the fact that some of us watched a little too much TV in the 1990s. But, seriously, "Ninja" has come to signify "a person who excels in a particular skill or activity." That's what the Orrick team strives for when it comes to providing tailored advice to growing tech companies and their investors. We hope that the OLNS also empowers you to be a Ninja entrepreneur.

If you'd like to discuss further, please contact us. We would love to learn about your experiences with these topics, so please share them with us. We constantly strive to evolve and grow to best serve our clients.

We hope you enjoy this ninth edition of our series.

On behalf of the Orrick Team,

Sven Greulich

Orrick — Technology Companies Group Germany

A. Venture Capital Deals in Germany

I. Introduction

Although the ever-growing herd of unicorns (Didn't these creatures use to be rare... Fun fact: according to *Pitchbook* the number of VC-backed unicorns worldwide is expected to exceed 1,000 sometime in early 2022. That is way more than the rarest horse breed in the world, arguably the *Galiceño*, a Mexican horse breed with a current estimated number of less than 100 according to the website rarest.org – we know, what an interesting piece of information, you are welcome) makes this hard to believe, actually quite a number of factors need to come together to make a start-up thrive. Amongst them are an innovative technology or product, a defendable competitive advantage, product-market fit, a killer founder team with incredibly strong execution muscles, a ton of luck and did we mention money, often a lot of money.

Venture capitalists (hereinafter, we will simply refer to them as **"VCs"**) have a large impact upon the start-up world. While only a fraction of young companies actually raises VC dollars, these companies often play a disproportionately large role in the technology space. While VCs fund companies across a broad spectrum of industries, a few sectors of the market claim the lion share of all VC funding, including for example software, TMT, biotechnology, industrial/energy and fintech. Amongst the many beneficial effects of a vibrant VC funding market and healthy start-up ecosystem as an increased innovation power, employment effects (both quantitative and qualitative) as well as positive macro and spill-over effects, we like to highlight a few of them:

- Start-ups (at least in the narrow tech-focused meaning we refer to in the little bubble that we focus our professional lives on) by definition apply advanced and novel technologies to either attack incumbents in existing markets with superior services or products or break new ground and develop new markets. Both fosters innovation but there is also another indirect way how start-ups help keeping the innovation dynamics high. Competition from start-ups keeps the incumbent players on their entrepreneurial toes (at least those who want to keep playing in the long run).
- While these estimates must always be taken with some grain of salt, there is wide agreement that a dynamic start-up ecosystem has a disproportionate positive effect on the job market. A recent study by the consultancy company *Roland Berger* came to the conclusion, that start-ups and scale-ups in Germany today already employ directly more than 400,000 people and that, if one includes the indirect employment effects in total, more than 1,600,000 employees directly or indirectly depend on our start-ups and scale-ups[1]. Besides these quantitative effects, there are also qualitative effects. Many start-ups require highly skilled employees with deep technology expertise or experts in the creator economy, thereby creating high value job opportunities and alternatives to "typical" careers in the corporate world. In particular, VC-backed start-ups can issue stock options to employees and seek to attract top talents on a global level, thereby creating a brain inflow into the national economy.

1 *Roland Berger,* Für ein Wirtschaftswunder 2.0 – wie Startups und Scaleups den deutschen Arbeitsmarkt beflügeln, 2021

- Start-ups tend to cluster locally (and no, not only locally between Prenzlauer Berg and Friedrichshain). These emerging technology hotbeds can make a region attractive for big tech and multinational players which in turn can help stimulate growth. But there is an even stronger macro-economic consideration. The typical life cycle of VC-backed start-ups through various financing rounds to exits with founders and employees participating in the exit proceeds can start a powerful cascade effect, where founders and staff cash-in their participation in case of a successful sale or IPO of their start-up, creating wealth that can be funneled back into new start-ups and spin-offs, which in turn creates a new group of cash-rich entrepreneurs and angel investors.

In Germany, according to the latest available statistics, 2021 is poised to set new record highs for venture capital funding across almost all stages. In addition, the exit markets are also on fire across a variety of channels, notably the IPO markets (where the first two quarters of 2021 were the best since the dot.com days of 2000). Due to the huge amounts that many venture funds have raised in recent years, still relatively modest valuation levels (especially in early rounds), at least when compared with the US and UK markets, and positive outlooks across many exit channels, the outlook for German start-ups to attract VC financings should remain strong for the foreseeable future. But maybe you should better not put too much trust in our predictions. Bullish we started 2020, then predicted nuclear winter after the arrival of a little virus, and then were finally proven wrong by record financial levels in the second half of 2020. It has been a tough year for a profession that prides itself on being farsighted. But anyway, let us talk about how to structure and implement venture capital deals.

Venture capital financings are not easy to obtain or close. Entrepreneurs will be better prepared to obtain venture capital financing if they understand the process, the anticipated deal terms, and the potential issues that will arise. Negotiating venture capital financing agreements raises a number of business, legal, tax, intellectual property, employment and liability issues. If you don't get these right from the start, there may be significant risks to the start-up, its founders and investors alike. If you're on the company side, you might not get your financing. And for all parties, there might be post-closing disputes, including misaligned incentives and an inability to attract investors in future financing rounds. Of course, many factors play into achieving success in a negotiation: who has leverage; whether there is competition among potential investors; how much risk a party is willing to absorb; and the quality and experience of the lawyers and the in-house teams at the negotiation table. But we believe that having a good understanding of common issues that arise in negotiations can go a long way to help avoid these pitfalls.

In this Guide, we present many of the most-contested issues in venture capital financings, presenting both the investor's and the founder's perspective. We want to provide practical guidance to the stakeholders in a young technology company, who are often unfamiliar with the venture capital process by outlining venture deal structures, explaining the industry terminology and some of the concepts and terms frequently used in term sheets and the fully-fledged investment documentation. VCs have cultivated a language and a structure of their own that helps them to communicate efficiently among themselves, but that is often opaque and sometimes outright confusing to outsiders. We want to level that playing field and help both founders and investors to clearly communicate, amicably negotiate, and hopefully agree upon fair financing agreements.

We especially want to help German technology companies be attractive for American and British investors. To that end, throughout this Guide we will take the perspective of a potential US or UK investor and give helpful tips to founders and early-stage investors of a German technology company to keep its "financeability" (*i.e.*, the ability of a company to raise future financing rounds) and attractiveness for potential later-stage American or British investors. We will also point out differences between the US and the UK so that this Guide may also serve as a useful tool for investors from these jurisdictions considering investments in young German technology companies.

THE START-UP ZOO

While VCs (and especially their lawyers) can certainly not be accused of using an over-simplistic language, their jargon is sometimes quite colorful, and they seem to have a particular knack for metaphors from the realm of mythical and other creatures. Here are just a few examples how VCs think about start-ups.

Unicorn: A classic by now, a unicorn is a privately held start-up valued at over USD 1 billion (that really used to be a lot).

Decacorn and Hectocorns: As there seems to be more unicorns than the fairy tales would let one believe, the start-up community needed to come with labels for truly outstanding young companies. Introduce the decacorn, *i.e.,* a privately held start-up valued at more than USD 10 billion. But as exclusivity adds value, the biggest decacorns soon broke out from the pack and established a new category for themselves, the hectocorns, a truly rare breed of companies with a private valuation of more than USD 100 billion.

Dragons: The term "dragon" is not uniformly used in start-up land. Some refer with dragon to a start-up that raises at least USD 1 billion in a single financing round while VCs sometimes refer to a start-up as a dragon if their exit proceeds from that start-up investment returns the whole fund. Though less poetic, some commentators refer to start-ups that have raised a total of at least USD 100 million as "scalers" while start-ups with a combined equity raise of more than USD 1 billion are dubbed "super scalers".

Zebra: A zebra is a start-up that is focused on earning money (be in the black) but also pursues a cause and is free of scandals (having a clean white slate).

Gazelle: A company that has an annual growth rate of between 20 and 40% over four consecutive years.

Gorilla: A company which has the biggest market share in the industry but doesn't have a monopoly. Gorillas are the undisputed market leaders but where successful gorillas are, **monkeys** are not far away. Those companies are an inferior copycat of a gorilla, undercut prices and exaggerate claims. Companies are referred to as chimps when they have a competing but different product than the gorilla. **Chimps** may be annoying, but they do not challenge the gorilla since they are less successful.

And here come the latest new neighbors in the start-up zoo:

Cockroach: This term is not very common yet and even less so in Germany. Cockroach start-ups do not depend on and do not want VC funding infusions; they are focused on profitability (*i.e.,* the only road to survival for a start-up without external financing) albeit at the price of slow(er) growth.

Camels: This is a term we sometimes heard during the early days of the COVID-19 pandemic and it may disappear quickly (almost as quickly as COVID-19, yes, right...). Camel start-ups are prepared to weather all conditions by focusing on a sustainable and enduring company whose business model does not rely on growth by all means.

In Chapter I, we start off with some general observations of what to do and what not to do in the early stages of a start-up in order to maintain its financeability for VCs later on. In this first Chapter, we will also give an overview of the investor landscape and the most relevant legal topics that an investor will cover in its legal due diligence. It is highly advisable to address these matters well before hitting the fundraising trail. We close this Chapter with an overview of the most relevant legal documents.

> **[…], there really are only two key things that matter in the actual term sheet negotiation – economics and control.**
>
> [*Brad Feld*, Venture Deals: Be Smarter Than your Lawyer and Venture Capitalist]

Chapter II presents the most relevant economic terms of venture capital financings in Germany. These provisions are mainly found in the investment agreement. We will start with a brief introduction to the concepts of pre- and post-money valuation and will in this context also discuss employee participation programs as they have obviously an impact on a company's valuation. We will then give an overview of how investments can be structured and implemented, followed by an introduction into the company's and founders' representations and warranties that investors will expect, as well as the remedies in case of breaches. Here, we will also discuss secondary share sales, which have become quite a common feature now that start-ups stay longer private and raise more money. While these provisions are usually not found in the investment agreement but rather in the shareholders' agreement, we also present here for didactical purposes the mainly economic-focused investor protection provisions around antidilution, preference dividends and liquidation preferences.

Chapter III dives into the most material provisions around the topic of who has control over the start-up's affairs. In German venture deals, these provisions are usually found in the shareholders' agreement. Control-related topics include for example provisions around the corporate governance of the company following the investment, including advisory boards, investor majorities/veto rights as well as share transfer provisions (including drag- and tag-along rights). While clearly also having significant economic relevance, we will also discuss founder vesting and leaver provisions in the context of the other share transfer provisions. In addition, we will present other relevant provisions, including US tax and IP covenants, provisions relating to matrimonial regimes (a German law particularity that can cause a lot of headaches down the road) and much more.

We will close our little tour with a brief discussion of what the road ahead might look like. While as already pointed out, we are really bad at predictions, as good lawyers we need to end on a cautious note. So we will close with a brief overview of deal terms that might change in a downturn (funding) environment (we hear you young founders: "grandpa is talking about the time when people actually went to grocery stores…", but times might change, eventually).

By necessity, this Guide cannot cover all relevant topics and it only presents our view. Each company and investor is different, and this Guide cannot substitute proper advice by a qualified lawyer on a case-by-case basis. Honestly, talk to your lawyer, it will make her[2] happy.

> **Please don't do anything stupid and kill yourself, it would make us both quite unhappy. Consult a doctor, lawyer and common sense specialist before doing anything in this book.**
>
> [*Tim Ferriss*, Tools of Titans]

[2] Although only the female form (she) is used throughout this Guide to make it easier to read, any reference to the female gender shall also include all other genders.

II. Setting the Scene

In 'From Zero to One', *Blake Masters* recounts *Peter Thiel*'s wise words on start-up infancy to his Stanford business students: "A start-up messed up at its foundation cannot be fixed." We might add that this applies to the general legal set-up of a start-up, its founder team compositions as well as the founders' choice of their early investors.

Most of the privately held technology companies require a number of funding rounds over their life cycle. The first round is often the smallest (seed capital), with investors being friends, family or angel investors. Because of the cost of retaining legal counsel at this stage of the game, many founders decide to skip it, especially as they are usually close to these early investors. Despite this, we would caution any founder who asked for our thoughts on the matter: it is in this early phase when founders and their investors would often benefit the most from qualified external advice.

1. SETTING UP THE COMPANY

Against this background, let us lay some groundwork and discuss what a suitable corporate set-up for most start-ups should look like, how founders should approach the composition of their cap table and how to avoid some common legal pitfalls during the infancy of a start-up.

1.1 Founder Holding Structures

Founders, or other people investing in the company, such as business angels, can hold their shares in the company either directly (one-tier structure) or through a wholly owned subsidiary (two-tier structure).[3] While holding one's participation through such a personal holding entity (we will use hereinafter for ease of reference the term **"Founder HoldCo"**) makes the transaction documentation a little more complex and incurs some costs for setting up and maintaining a separate legal entity, it is usually advisable and should be implemented right from the start, as changing from a one-tier to a two-tier structure at a later point in time can have negative tax consequences and channels scarce liquidity into the lawyers' greedy pockets.

The main reasons and benefits for holding one's shares in the start-up through a Founder HoldCo are tax-driven. We briefly outline them below. Note that the following comments are directed at German resident and taxable founders and that the situation may be different in other cases.

> As a rule of thumb, each founder should hold her shares in the start-up through her own founder holding entity.

Taxation of Capital Gains

Even though we try our hardest: We cannot spare you the tax-topic completely. But to sweeten-up the tax reading a little, we will start with some good news for you: A well thought-out holding structure will most likely be able to save you money, potentially a lot of money, like really a lot of money. Therefore, bear with us and remember what *Ben Horrowitz* said: "If you are going to eat s***, don't nibble." (we have been waiting for eight editions of the OLNS to finally bring that quote which is a favorite of one of our co-authors).

[3] In Germany, a Founder HoldCo is often organized as a UG (*haftungsbeschränkt*) rather than as a GmbH in order to save some setup costs (while the UG (*haftungsbeschränkt*) is somewhat less flexible than the GmbH, it has no real minimum capital requirements compared to EUR 25,000 minimum capital for the GmbH and has somewhat lower incorporation costs.)

A Founder HoldCo offers tax advantages if the founder wants to sell her participation in the start-up. Without a Founder HoldCo, she would incur up to 28.5% personal tax cost on capital gains when she sells her participation in the start-up (potentially increased by church tax). Using a Founder HoldCo, however, would allow the founder to reduce the taxation on capital gains from selling her participation in the start-up to effectively max. 1.5%. The Founder HoldCo is eligible for a 95% tax exemption on capital gains and the remaining 5% are taxed at a total of approximately max. 30% corporate tax (including the solidarity surcharge) and trade tax, reducing her tax to approximately max. 1.5%. Church tax may still come on top in a scenario where the founder would hold her shares in the start-up directly but would not accrue to capital gains in case of a Founder HoldCo.

If the founder then wants to enjoy the gains from the exit on her personal level and pays out a dividend from her Founder HoldCo to herself, this will neutralize the tax advantage of the personal holding company. However, depending on the volume of the capital gain, the founder may only need a fraction of the wealth on her personal level, with the remainder being available for reinvestments out of her Founder HoldCo in other ventures or assets (shares, property, etc.). Also, with a Founder HoldCo, the founder can determine the point in time when the tax on the distribution accrues. Without a personal holding company, the tax would accrue upon the divestment of the shares in the start-up by the founder.

Taxation of Dividends

Similarly, a Founder HoldCo structure may offer tax advantages if the start-up pays dividends to its shareholders, depending on the circumstances. Without a Founder HoldCo, taxation on the personal level may go up to 26.4%, excluding church tax, whereas with a Founder HoldCo, the tax burden would be limited to approximately max. 1.5%, but only if the founder's personal holding company holds at least 15% of the nominal capital of the start-up (including in suitable cases through pooled holdings of some or all founders, see below). If the founder holds less than 15% in her start-up, (merely) for dividends, a direct investment in the start-up would be more tax advantageous than holding the investment through a Founder HoldCo. Should the Founder HoldCo be at risk of being diluted below the level of 15%, and if dividends are a serious option, then two or more founders (or any other shareholder) may pool their Founder HoldCo's participations through another joint holding entity. This would, in effect, establish a three-tier structure, where the lower-level Founder HoldCos hold a joint shareholding of 15% or more of the nominal capital of the start-up, and benefit from the low 1.5% effective taxation and the 15% thresholds are met on the upper level as well ensuring 1.5% effective taxation on that level.

Each founder should therefore ask herself whether the future business case includes high dividend payments and the founders maintaining a relevant stake in the company or whether she will rather play the "exit game". In the latter case, a Founder HoldCo / a two-tier structure will be more tax advantageous.

A Two-Tier Structure Preserves Options for Future Restructurings – Namely a US Flip

We will talk in a second a little bit more about implementing a German/US holding structure as an alternative to a pure "German set-up" right from the start. Here, it suffices to say that getting into such a structure after the German start-up has been incorporated can be really (read: often prohibitively) tax expensive for all shareholders holding their shares in the start-up directly, *i.e.*, setting up Founder HoldCos early on can help preserving the option of getting into a US/German holding structure in the future through the famous "flip".[4]

[4] You can find details about the pros and cons of a US/German holding structure and all you ever wished to (not) know about the tax consequences in our Guide *OLNS#7 – Flip it Right*, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/olns-7-flip-it-right.pdf.

In a nutshell, a "flip" refers to the "transfer" of a German start-up to a US legal structure. In this process, the shareholders "swap" or "flip" their shares in the business-carrying (German) start-up (usually referred to as **"OpCo"**) for shares in a newly established US holding entity (usually a Delaware Inc. and hereinafter referred to as **"US HoldCo"**). Usually, assets, intellectual property rights, and employees remain with OpCo while US HoldCo assumes the role of a holding and management company that sometimes also enters into business relationships with customers in the United States (though for various reasons, it is often more advisable to establish another new US company beneath US HoldCo, *i.e.*, a sister company to OpCo, to act as operating company in the US market).

Here is a brief and simplified summary of the typical steps to be taken in a flip. The best transaction structure will, however, always depend on the specific case at hand.

- Step 1: The current shareholders of OpCo (*i.e.*, the founders or their Founder HoldCos and the existing investors) incorporate US HoldCo.
- Step 2: The current shareholders of US HoldCo and potentially existing and/or new investors enter into the typical agreements governing their rights and obligations as future shareholders of US HoldCo, including exit options, preference rights, etc.
- Step 3: The existing shareholders of OpCo transfer 100% of the shares in OpCo to US HoldCo. This will require a transfer deed to be notarized in front of a German notary. In exchange, the existing shareholders of OpCo receive shares in US HoldCo.

If a US/German two-tier set-up makes sense for your start-up (in particular to help with early-round financings), it is usually tax beneficial to move into that structure as early as possible.

However, the share swap underlying the flip is a taxable (sales-like) event under German tax law. Unlike for share swaps involving EU/EEA companies, a flip into a company organized under the laws of the United States cannot be effected on a "no gain/no loss" basis and there is no rollover of acquisition costs under the German Transformation of Companies Tax Act (*Umwandlungssteuergesetz*) available. Thus, when implementing the flip, the current shareholders of OpCo will record a gain (loss) at the balance of (i) the fair-market value (*gemeiner Wert*) of OpCo shares and (ii) their carrying book value and transaction costs, each at the time of transfer of title (or if differing, upon transfer of economic ownership) in the OpCo shares to US HoldCo. With respect to the effective tax burden, the situation differs whether the respective shareholder of OpCo which transfers its shares to US HoldCo is a German corporation (such as a Founder HoldCo) or a natural person subject to German taxation.

- For corporate shareholders, the regular German tax relief should often be available, *i.e.*, the effective tax rate comes down to 1.5% of the respective taxable gain resulting from the flip.
- In contrast to that, if the shareholder is a natural person subject to German taxation and has been holding in the last five years an equity stake in OpCo of at least 1%, her gain from the flip would only be 40% tax exempt, with effective taxation often ranging up to approximately 28.5%.

1.2 US/German Two-Tier Holding Structures as an Alternative

Congratulations, you made it through the tax groundwork and have a vague memory that holding shares in a start-up through a founder holding entity is in most cases a good idea, well done. There is one further structuring consideration we want to share with you in this context. While a Founder HoldCo makes sense for many founders, the following paragraphs are for a subsegment of start-ups for which a cross-border US/German holding structure might be better suited than a purely domestic German structure.

As one of the world's leading tech law firms with significant presence in both the US and Germany (took us twenty pages but here comes the bragging), we are frequently asked by (prospective) founders and investors of German start-ups whether they should set up their German technology company in a US German holding structure. In such a cross-border two-tier holding structure, the founders and investors indirectly hold their equity in the German start-up (*i.e.,* OpCo) through a new US holding company (*i.e.,* US HoldCo). This structure comes with a variety of benefits, most notably an arguably better access to early stage financing opportunities in the richer US funding ecosystem. Other advantages include improved exit opportunities as well as the opportunity to offer suitable talent a "Silicon Valley style" equity-based employee participation program. However, moving a German start-up into such a US holding company structure is a major corporate undertaking that comes with a variety of potential drawbacks and requires close cooperation of founders and their investors as well as advice from legal, accounting and tax experts with experience on both sides of the pond. Keep in mind that once such a structure has been established, there's usually no going back. While "backflips" from a US company into a German holding company (sometimes also referred to as "inversion" transactions) are legally possible, they often come with a huge tax bill and a host of practical issues.

Nevertheless, we think that it makes sense for German start-ups to consider a US/German two-tier structure early on in their lifecycle, as the mechanics only grow more complex later in their life when more parties on the start-up's cap table with potentially diverging interests need to be coordinated. In addition, a flip in later stages of the start-up's financing lifecycle might become prohibitively expensive from a tax perspective.

Advantages of a US Holding Structure

There are various potential benefits for a German company that adopts a US holding structure. Not only do US companies still have better access to US investors, but the new structure might also have a positive impact on its valuation and exit opportunities. It might also grant the start-up access to a richer talent pool, not only in the tech hotbeds in the United States but also in other international hubs.

- Access to Investors: A central motive for a US holding structure is that in many cases the start-up will receive improved access to the significantly more liquid US venture capital markets. Despite the enormous progress that the European start-up and funding ecosystems have made over the last couple of years, the US investor base still has a significantly greater number of potential investors, a more vibrant and developed venture capital scene, and a stronger disposition to invest, especially in riskier ventures than German or even European investors. Also due to deeper sectoral diversification, US investors may sometimes offer better know-how, contacts and guidance for first time founders and early-stage companies. Tech giants with massive exits, such as Facebook, Google, Instagram and countless others, have also created a rich secondary ecosystem of people who have scaled them before, be it on the technical or operational side. This reservoir of knowledge isn't as readily available in other parts of the world and raising money in the Bay Area can be a great way to tap into this knowledge and ecosystem.
  For obvious reasons, US investors will often feel most comfortable with the corporate mechanics available in a US entity – e.g., they understand and are comfortable with the way in which the rights of preferred stock can be structured under Delaware law while the nuts and bolts of our awesome German corporate law system remain alien to them (not to speak of the notarization requirements for many corporate transactions and financings involving a private limited liability company (*Gesellschaft mit beschränkter Haftung* (**"GmbH"**))). However, founders should think carefully about their chances of raising money in the US and how much having a US holding company will actually improve their chances of raising money. At the risk of sounding a bit too pessimistic (a common trait among our profession…), founders should have thought about the following aspects before they venture into a US holding structure. For later stage companies (Series B and beyond), we noted that over the last couple of years many US VC funds have become much more comfortable with investing in a GmbH (that is, of course, if they invest in companies outside the US at all). In addition, we see an increasing appetite of US investors for earlier financing rounds in German companies, and many of them already came in on the ground floor, *i.e.*, in Series A financings without requesting the start-ups flip to the US structure. Furthermore, for many early-stage companies, the best chances of getting funded are found more on a local level. Thus, US early-stage investors will often take a pass despite a US holding company being established unless a founder is prepared to move there and pursue a US business plan. In other words, a US holding company often is a necessary – but not sufficient – condition for US investors to lead a Seed or Series A financing.
- Valuation and Exit Options: We don't want to comment on the merits of these claims, but the reality is that many (primarily US-based) VC investors believe that a US entity will offer more advantageous opportunities for an "exit", either through an acquisition or an initial public offering (**IPO**). The main reasons for this argument are: (i) start-ups with a US – this usually means a Silicon Valley – story can often fetch higher valuations; (ii) chances are that many of the potential acquirers will be US-based private equity investors or corporations; and (iii) the US has some of the world's premier stock markets that, compared to other internationally recognized stock exchanges, seem particularly suited for IPOs of young technology companies.

- Access to Talent Pool and Employee Incentive Programs: Finally, tapping into the rich talent pool of Silicon Valley and other US tech hubs is easier for a US legal entity as it can offer standard, market-tested, equity-based employee participation plans with stock options. One potential disadvantage that German tech companies face when competing for talent in the US tech hubs is that often they cannot offer their prospective hires equity compensation. While under certain circumstances shares in a Delaware C corporation can provide US taxpayers with tax advantages, such tax advantages are not available for US taxpayers under typical German market employee participation programs (particularly if they are phantom equity or "virtual" programs, which is still the standard approach in Germany).

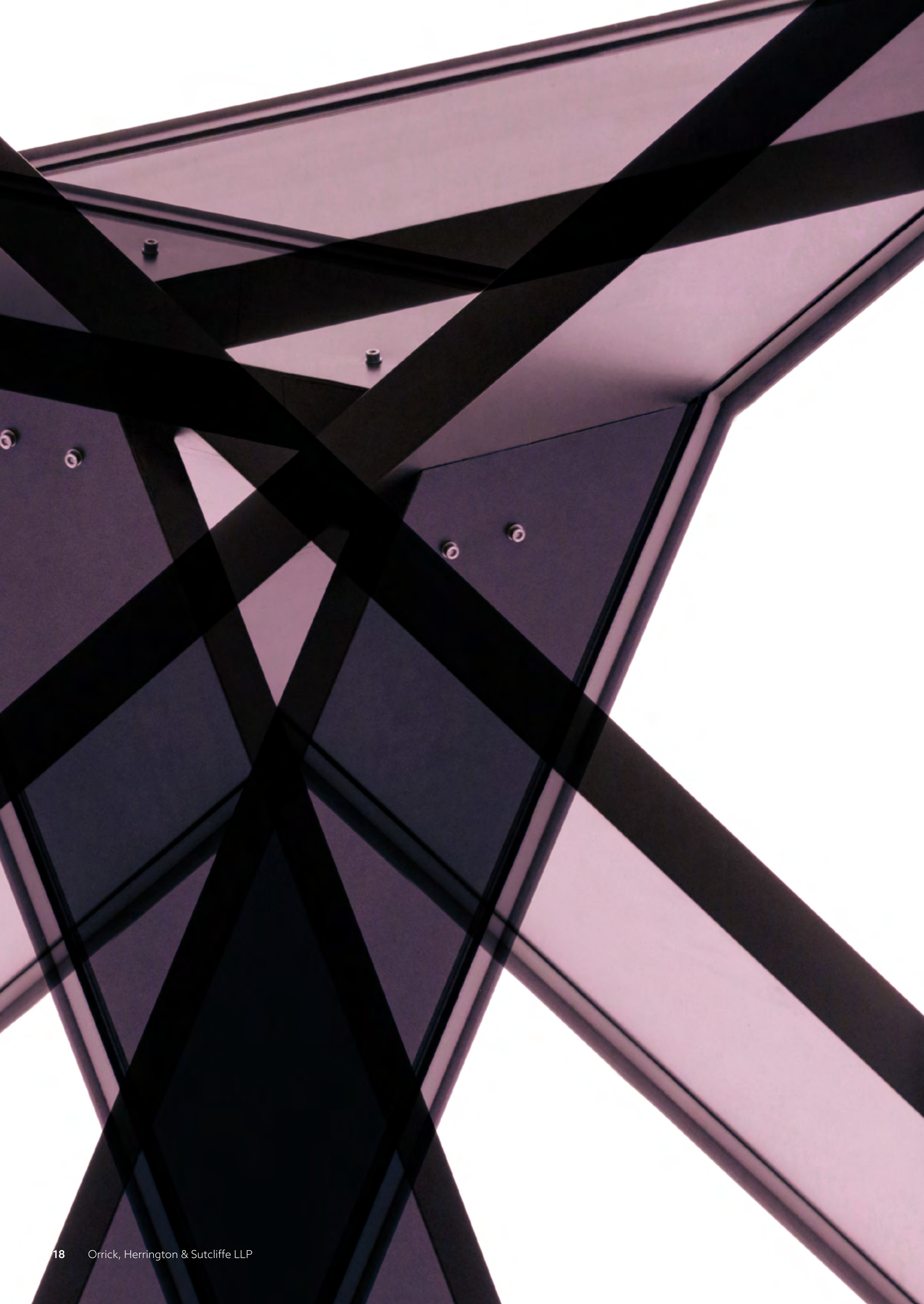
Disadvantages of Having a US Holding Structure

On the – be careful, lawyer humor ahead – flipside, the founders also have to assess the disadvantages and potential drawbacks of a US holding structure. The main issues are:

- Additional Complexity: Let's get philosophical for a moment. "Complexity is the enemy of execution." Sounds sophisticated, right? Yes, we know, that quote is not ours but stems from *Anthony "Tony" Robbins*, bestselling author and successful coach, and it is also taken out of context here; however, it is catchy and summarizes one of the most relevant drawbacks. The unknown US legal system and the two corporate and tax layers will simply add complexity to your business structure. Complexity can be like a giant anchor threatening the only two real advantages many start-ups have: speed and focus.

- Tax Considerations: Most notably, when establishing a two-tier structure, the founders need to be aware of various tax pitfalls. For example, professional advice needs to be obtained in order to ensure that the US HoldCo does not become a "dual resident" from a tax perspective. A flip will add greater tax complexity in another regard as well since OpCo as a subsidiary of US HoldCo is a so-called "controlled foreign corporation" (**CFC**) and needs to be included in the US tax return of US HoldCo, although, due to the German-US double taxation treaty, income of OpCo will still be taxed in Germany. In addition, rather extensive reporting and accounting obligations apply with respect to OpCo now being a CFC.

- Transaction Costs: A further concern are the out-of-pocket costs of setting up a two-tier structure. These costs might run into the tens of thousands, although flip transactions are more costly than simply setting up a two-tier US/German structure from scratch. One thing German start-ups should also be aware of is that their legal costs after a move to the US will be higher (though we would usually counsel our clients to think of legal costs more as an investment into avoiding higher costs down the road, but we may be biased here...).



2. THINKING ABOUT YOUR CAP TABLE AND WHAT IT WILL TELL ABOUT YOU

2.1 Prospective Investors will Look at your Cap Table

The capitalization table (more commonly referred to as cap table in venture speech) is a spreadsheet listing all shareholders and holders of options and any other convertible securities, along with the number of shares (separated by share classes), options and convertible securities held. To give a complete picture of the economic participations in the company, the cap table may also contain the already allocated as well as the yet allottable virtual shares under a typical German market virtual employee stock option plan (for details of such plans see below under Chapter A.III.2). Although virtual shares or virtual options do not give their beneficiaries the right to acquire "real" shares in the company, we will see that they still play an important role when it comes to the distribution of the proceeds in an exit event (usually the sale of the company or its IPO).

DIFFERENCES TO US AND UK INVESTMENTS: TRANSPARENCY OF SHAREHOLDINGS

In the US, there is no shareholder register publicly available for privately held companies. In the UK, an accurate and up-to-date shareholder register can only be accessed at the registered office of a privately held company and only following delivery of a written request. This can be contrasted with the situation in Germany: for every GmbH, an up-to-date list of all shareholders must be filed with the commercial register at the local court of the company, including details about the shareholders' identity, number of shares and ownership percentage. The shareholders' list is publicly accessible (see www.handelsregister.de) though a small fee applies. However, this list only shows the non-diluted cap table while warrants, options, conversion rights or virtual shares are, however, not part of the shareholders' list, and there is no public register for these kinds of rights.

In 2017 and recently in August 2021, the German legislator has tightened the transparency requirements by introducing and extending a general transparency register (Transparenzregister). German limited liability companies, stock corporations and many other entities (including private equity funds, registered partnerships etc.) must make inquiries about their so-called beneficial owners and file their beneficial owners with the register. Beneficial owners are natural persons who directly or indirectly hold or control more than 25% of the shares or the votes in the reporting company. The possibility of exercise of control over shares, or votes in a comparable manner, can also result in a reporting obligation of natural persons as beneficial owners to the transparency register. Such exercise of similar control can occur if participations of the above-mentioned size are held on trust or voting agreements established between several shareholders. While the shareholders' list at the commercial register is publicly available, access to the transparency register is staggered: Authorized public authorities and AML obligated persons have unrestricted access to the transparency register. The public has access to data with limitations.

With effect as of 1 August 2021, the scope of the transparency register has even been extended. Beneficial owners whose identity is already evident from German registers other than the transparency register were previously exempted from the reporting requirements. Now, the new legislation also obliges companies where the ownership structure is already accessible in the commercial register to nevertheless register (even if there is no ultimate beneficiary owner) with the transparency register. In accordance with EU law, the German legislator hereby implemented a general register which shall contain the ultimate beneficial owners (or at least the directors/management, so called fictious beneficial owners) of any legal entity and registered partnership.

A healthy cap table reflects the founders' judgement and can be a strong signaling device (good and bad) that illustrates the business' potential for growth as well as the founders' judgement. When evaluating a potential new investment, many investors will first have a look at the company's cap table and here are just a few of the things they will consider:

- Cap tables can get messy with too many small investors with no clear value proposition on how such investors can contribute to the start-up's future success (we will come back to this).
- Reputable VC investors and angels might not pay the highest valuation but having their names on the cap table can impress potential business partners and key hires. Even more importantly, they can be the missing link between having a great vision and product idea and exponential growth.
- It is also important for the founders to keep enough equity during the early phases. For later investors it can be a real roadblock if their prospective founders do not hold enough shares in the start-up, read have enough skin in the game and financial incentives to work day and night to grow the company. For the same reason, the prospective investor will also want to make sure that the pool of stock options (be they equity-based or virtual) available to the company's employees is big enough.
- Too much founder dilution in the early rounds can be an indication for trouble ahead. Working with angels or company builders that overreach and degrade the founder team *de facto* to employees with a little equity incentive reflects badly on the founders' judgement. Investors will anticipate future financing rounds, *i.e.*, further dilution of the founders' stake and will ask themselves if the founders will continue to be happy with the split when the memory of the support they got from the early backers (or sometimes more correctly were supposed to get) fades while the hardships of the daily life of an entrepreneur weighs heavily down on them. We then sometimes see attempts to fix what was an inequitable split of the company from the start by giving founders stock options under employee participation programs (note – in Germany, these allocations will usually be significantly less tax attractive than initial equity) but these are almost always second-best solutions to a problem that with some foresight could have been avoided.

Don't mess up your cap table.
Avoid the three ugly "too's":
too much founder dilution,
too many shareholders and
too much dead equity for advisors and early backers with no meaningful role going forward.

2.2 You can never have too many Friends, but maybe too many Shareholders

"Messing up the cap table" summarizes a phenomenon we sometimes see in early-stage companies. In an effort to get their company off the ground, founders simply take whatever money comes in the door, resulting in numerous investors, who are often not particularly experienced, investing small amounts in the company in exchange for shares right away (in case of a direct investment) or at a later stage (in case of a convertible loan investment). Such investors are sometimes referred to as "dead equity" as they only bring some money but otherwise don't add value.

Having too many of such small shareholders in the cap table can create problems down the road. Unlike in the US, under German law, even the smallest shareholder cannot be reduced entirely to the economic interests vested in their shares (*i.e.*, the right to receive dividends or participate in an exit). Rather, each shareholder has certain unalienable participation rights, including the right to be invited to a shareholders' meeting, attend the meeting and (unless the company has issued non-voting shares, which is not very common in Germany) vote their shares and challenge resolutions adopted by the shareholders' meeting. In addition, every shareholder in a GmbH has a statutory right to inspect the company's books and request information on the ongoing business (subject to certain limitations).

Professional VC investors may also be reluctant to work with these often rather unsophisticated investors because they fear that they will not appreciate the business decisions and changes to the company's setup and/or financing agreements when the company progresses on its growth trajectory or runs into problems. For example, in a subsequent financing round, it might become harder to enter into a new financing documentation (for an overview of these agreements, please see below under Chapter A.III.3.) If the existing minority shareholders do not come along and also enter into the new agreement, this can impact the new financing round and sometimes make it necessary to maintain the "legacy" agreement with only a subset of the shareholders and the new investor entering into the new agreement.

We are aware that sometimes there may simply be no viable alternatives to numerous small-ticket investors in the very early phases of a company. Here are some options to mitigate the impact on the cap table and future financing rounds that founders may wish to consider:

- Pool the investors. If the investment amount is sufficient to justify the additional setup and administration costs, it might make sense to pool the small investors in a separate investment company (InvestCo). For example, the founders could set up a separate InvestCo in the legal form of a limited liability partnership under German law, *i.e.*, a GmbH & Co. KG, in which they control the general partner and/or a managing limited partner. All of the small investors would become limited partners of InvestCo and invest only in InvestCo, which in turn would become a shareholder in the start-up and provide the investors' funds to the company. This way, the small investors can be kept out of the cap table of the company, and given their limited influence on InvestCo, there is little risk that they might "highjack" InvestCo and use InvestCo's rights as a shareholder in the company for obstructive purposes.

  As a less complex alternative, the small investors can enter into a pooling agreement with a designated investor (or founder) acting as a pool leader (see also under Chapter A.IV.3.3). While the small investors would still become direct shareholders of the company, they are required to pool their voting and other shareholder rights. By giving a sufficiently broad power of attorney to the pool leader, it can be ensured that these minority shareholders will "speak with one voice".
- Give convertible loans, not shares. In the early phases of a company, it can make sense to have small investors first grant convertible loans to the company rather than subscribing for shares in the company right away. This way, the potential negative consequences of having multiple shareholders can be somewhat delayed up until a more sophisticated institutional investor will come on board and help to instill some discipline into the cap table. We will discuss some aspects of financing a young company through convertible loans further down below (see Chapter A.II.4.2).

2.3 Deciding upon the Equity Split amongst Founders

We are sometimes asked how soon-to-be co-founders should split the equity amongst themselves. No idea, why someone would ask a lawyer such a question, we are usually pessimistic and depressed by nature and tend to see only the cases that somehow went wrong...

> An even equity split amongst founders can be a negotiated outcome, but it should not be the default option. Have that discussion upfront and understand founder team dynamics. Please...

Company shares are finite, and a reasonable, fair and – we will come back to that – sustainable distribution must be found. Especially young, inexperienced founders tend to avoid conflicts at this point and agree on an equal distribution (deploying all our spreadsheet skills that leaves a four founders team with four more or less happy 25% shareholders). We are NOT saying that this might not be an equitable distribution. But what we are saying is that more or less automatically resorting to an equal distribution can just delay an inevitable conflict amongst founders and that an ill-considered equal distribution can cause negative associations with potential investors.

There is no universal formula to determine the right split. We know that there are software solutions out there that claim otherwise[5], but we are old-fashioned and believe in the merits of a good civic discourse. That is the lawyers' Latin for: "talk it through and if need be have that heated debate now." There is no right split, just something that is appropriate for a specific start-up and that hopefully provides long-term stability. However, we think that there are some general principles and considerations that can help guiding the founders. Here are a few goalposts that we find useful:

Don't Look in the Rearview Mirror

Become aware of the consequences of choosing your split. The distribution of shares is likely the wrong moment to primarily reward past efforts. In the grinding reality of start-up life (we realize that we really sound like old folks now, but anyway...) prior success will soon fade into the background. Rather, we think that the share split should be predominantly a future-oriented allocation that motivates future key contributors and incentivizes continued loyal service delivery. Giving equity to co-founders is not only a matter of remuneration, but foremost a matter of future motivation and appreciation. Especially the 'idea generators' of a start-up have to take a deep breath and recognize that an idea in itself does not make a start-up and that investors will evaluate the team's execution power.

All Co-Founders are Equal, Right?

Furthermore, you must decide whether an equal split suits your company and your corporate culture, or whether you would prefer an unequal but weighted allocation. There is a substantial group of investors and start-up colleagues that argue that an equal split will create a stronger sense of community among co-founders and thus maximize the motivational effect.

> Almost all start-ups fail. The more motivated the founders, the higher the chance of success. Getting a larger piece of the equity pie is worth nothing if the lack of motivation on your founding team leads to failure.
>
> [*Michael Seibel*, Y-Combinator]

5 Here are just two examples: https://cofounders.gust.com/ or https://www.embroker.com/blog/startup-equity-calculator/

There are good arguments for this position. An imbalanced split leads to investors getting the impression that there are less valuable founders on board. *Michael Seibel* from the Y-Combinator puts it this way: "Investors look at founder equity split as a cue on how the CEO values his/her co-founders. If you only give a co-founder 10% or 1%, others will either think they aren't very good or aren't going to be very impactful in your business. The quality of the team is often one of the top reasons why an investor will or won't invest. Why communicate to investors that you have a team that you don't highly value?"

On the other hand, one hears warnings that an even split could make an immature, unreflective and thus shortsighted impression on investors. "A quick, even split suggests that the founders don't have the business maturity to have a tough dialogue", says *Noam Wasserman* who researched a larger number of founders split decisions. Business-mature founders who would really face the split question and have had an open-ended exchange about this would come to an uneven split in many cases, he argues. While an even split will avoid an initial conflict, it is often more susceptible to some founders feeling underappreciated and not rewarded for their stronger future contributions.

We don't know which side is ultimately right but if you allow us a lame sport analogy: In football (and yes, we are talking about the real football and one shouldn't call it soccer, but that is a different story), in order to win, it requires a team of highly motivated and skilled individuals who work seamlessly together in the pursuit of a great vision (score at least once more than the other team, see football isn't that complex after all) and yet successful center forwards earn more than defenders.

What makes this discussion difficult is that it is the hard-to-quantify factors that determine a founder's potential future contribution to the start-up's success. These factors include, *inter alia*:

- Unique technical expertise and relevant domain know-how;
- General experience in getting a start-up off the ground and scaling its business;
- Pre-existing IP;
- Storytelling and sales skills – arguably one of the most important and yet often underrated qualities of a good founder; and
- Willingness to sacrifice as well as personal and time commitments.

But which values are particularly important for the future of your company, even indispensable? Especially for founders with different backgrounds, this question will often reveal different perspectives, as *Lara Hodgson* (co-founder of Nourish and NOW Corporation) knows. In particular, people from professional environments, consultants, lawyers, etc., would often stress the time/commitment factor as a primary measure of value. But hours worked alone will not lead a start-up to success, or as Lara puts it: "As someone that comes from an entrepreneurial background, a unit of time is not worth a dollar to me, if there is no result. I'm always looking at what result – what asset – has been created from which I can derive future dollars." Ideas that have not yet been converted into patents are also often added as a value at this point of the consultations.

> ...[T]he 'idea person' insists that the idea is 90% of the value (and 90% of the equity). In the real world, the 'idea' is a very small part of the overall equation. A start-up is all about 'execution' – meaning the equity should be allocated based on the value that each partner brings to the table.
>
> [*Martin Zwilling*, Business Angel]

2.4 A Special Breed – Corporate Venture Capital Investors

As should have become clear by now, founders should carefully think about the selection of their cap table and their investors. In this context, we want to briefly put the spotlight on a special kind of investor, the corporate venture capital investor. A group of investors that comes with a some potentially material advantages but also a bag of challenges.

Digitization and the use of disruptive technologies are rapidly reshaping value chains – and at times even entire industries. The world's business leaders strive to stay ahead of these developments and prepare their companies for an increasingly dynamic and unpredictable future. One of the tools from the innovation toolbox that many corporations apply is *Corporate Venturing* and in particular its sub-category *Corporate Venture Capital* (**CVC**).

Corporate Venturing is a catch-all phrase for a wide variety of forms of equity-based investment by corporate investors into young technology companies, as well as other forms of non-equity-based cooperation between established players and start-ups (*e.g.*, industrial partnerships). Corporate Venture Capital is a sub-category of Corporate Venturing – it's a similarly broad term describing equity and mezzanine investments made by a corporation or its investment entity into a start-up. Beyond this basic definition, the range of models and systems deployed by corporate investors is very diverse. This makes it crucial to understand what CVC and its various manifestations are and the role it can play, or to compare and evaluate various approaches to CVC to find the right mix for its own organization.

We cannot go into the details in this Guide[6], but want to briefly summarize (from the start-up's perspective) the main advantages and potential disadvantages of having one or more CVC investors on the cap table. Founders need to weigh the pros and cons carefully as CVC investors (unless they are pure-play financially motivated and have implemented incentive schemes similar to their institutional VC peers) have motivations and incentives that somewhat differ from the entirely financially driven VCs and business angels.

But first, let's state something that in our experience lies at the root of many failed CVC initiatives and their investments. While CVC does have elements of venture capital, it's also different. Private venture capital (VC) is a singular pursuit. VC funds assess and invest in high-growth potential businesses by deploying funds raised from external investors, known as limited partners (LPs). The sole objective of such a fund is financial return for its investors. On the other hand, CVC differs in a number of ways. Corporate Venturing, and CVC in particular, are usually measured on both strategic and financial metrics. At the risk of oversimplification, there are two main objectives to CVC:

- "Learning" – developing the strategic capabilities of the parent corporation as well as gaining access to new markets and technology.
- "Earning" – seeking sources of financial return. With respect to "Earning" as one of the objectives of CVC, there is an overlap of goals with VC funds. The distinction criterium is therefore "Learning" and for determining the appropriate structure of a CVC the importance of the "Learning" aspect should be put in context with the "Earning" aspect.

6 If you are interested in our (actually still pretty optimistic) take on CVC and how corporates and start-ups should approach their relationship, please refer to our Guide *OLNS#4 – Corporate Venture Capital*, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/olns-04-corporate-venture-capital.pdf.

So CVC investors should not be painted with the same brush. They are heterogenous and the two motives summarized above (which belies the many real-world differences in approaching CVC) have far-reaching consequences. For example, the placing of CVC activities under either motive could determine how a start-up and potential co-investors perceive the corporate investor. And like it or not, the perceived objective of a CVC unit and its underlying incentive schemes will influence its investment decision-makers and portfolio management, as well as its internal team makeup and their capabilities – whether intended or not.

Potential Advantages from the Start-up's Perspective

Classical VC investors claim to invest "smart money" by combining their financial investment with advice, know-how and access to networks. In today's funding environment, for numerous start-ups getting financed is often not their most relevant obstacle on the growth trajectory. Their biggest challenge is to scale the business fast. Here, CVC investors frequently claim that they bring "smart and strategic money" to the table by offering services designed to help the portfolio company create and/or capture value. In this respect, potential benefits for the start-up resulting from a CVC investment may include the following[7]:

- Financial support and a long(er)-term perspective compared to VC investors;
- Domain expertise and strategic and tactical advice, especially in the start-up's industry and business;
- Operating support;
- Access to the corporate investor's assets, particularly R&D capabilities;
- Access to the corporate investor's sales and distribution network and support of the start-up's internationalization strategy;
- Overcoming the "liability of newness", credibility transfer and validation in the eyes of the public; and
- Providing a potential exit path.

10 THINGS

A START-UP SHOULD ASK A POTENTIAL CVC INVESTOR

#1: What is the mission of your CVC program – financial revenue or strategic impact? Which priority tops the other?

#2: When would you consider an investment in my company a "success" and why?

#3: What do you bring to the table besides the money?

#4: How is your company going to deliver the value you promise and what is your track record for delivering such non-financial benefits? Can we discuss with some of your portfolio companies their experiences?

#5: Are you willing to announce your investment to the public?

#6: Would you insist on taking a board seat and do you expect any preferential treatment in future financing rounds and/or M&A transactions?

#7: Who is making the investment decisions in your organization and who decides on follow-on financings? What is your track record on participating in follow-on financings?

#8: How is your CVC unit organized – as an integrated business unit or as a separate legal entity?

#9: Who are the people in your CVC unit, what is their expertise in scaling a business and what interfaces do they have with other business units?

#10: What does the financial and non-financial incentive and reward structure for the investment team look like?

Potential Disadvantages from the Start-up's Perspective

Here are some of the potential risks and downsides start-ups need to consider before taking CVC money.

- Mismatched goals and misaligned incentives;
- Slow decision processes and corporate bureaucracy;
- Negative signaling (especially for VCs); and
- Diminished exit prospects.

7 For a detailed discussion, please see our Guide *OLNS#4 – Corporate Venture Capital*, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/olns-04-corporate-venture-capital.pdf.

Specifically, if the CVC unit has been given a primarily strategic mandate, there can be a slippery slope leading easily to misalignment. If the strategic mandate is interpreted by the CVC unit in extracting strategic value from the start-up, this will lead to a corporation-centric mindset, and "what can the start-up do for us and our business units" becomes the guiding principle. However, the other stakeholders, notably founders and existing investors, might beg to differ as they fear that too much focusing on the strategic value for the investor might at best distract founders and at worst harm the value of their shareholding.

In addition, there can be plenty of intra-investor misalignments. Delivering on the promise to leverage the corporate assets and providing more than money is often easier said than done. On paper, there seems to be a great complimentary partnership, but it often fails in the execution phase. While in theory the promise to provide the start-ups with access to the corporation's sales channels and making intros to the customer base seems to be low-hanging fruits and should make for a compelling sales pitch for the CVC investment team, the employees that could deliver on this promise within the parent organization might well lack the incentives to do so. These employees often have their own accountability package, priorities and agenda. Here, it is crucial for the corporate parent organization to implement incentive schemes and create the – yes, we know this is a big word – right culture for the relevant corporate employees to leverage the corporate assets in favor of start-ups.

3. KEEP IT SIMPLE, AT LEAST INITIALLY

There is a big difference in the nature of venture capital investments depending on the stage of the company on its growth trajectory. To put it simply, a Series Seed differs from a Series C financing round not only in the ticket size but often also in deal terms[8]. The subsequent Chapters of this Guide will present concepts and deal terms that may be included in later-stage financing rounds but may not necessarily be appropriate for the very first funding rounds (*e.g.*, US investor tax covenants, IPO-related clauses). Early-stage investors and the founders should, however, be aware that everything they agree to in the first financing round will likely form the basis for corresponding provisions in the subsequent rounds. In particular, all later-stage investors will usually request at least the same preference rights as the early-stage investors and potentially more.

Due to this path dependence, unwinding bad terms is difficult. Ideally, the Series Seed or at least the Series A documentation is a strong foundation and precedent for the terms of future rounds. Good foundations make the next term sheet and financing round fast and simple, as future investors just step into the same straightforward terms.

KEEP IT SIMPLE – liquidation preferences should be non-participating and *pari passu* for all preferred shares, different classes of preferred shares should vote as one class and without special vetoes on reserved matters and drags. Vetoes for certain investors are rarely helpful.

[*Tilman Langer*, General Counsel of Point Nine Capital]

Against this background, here are just a few pitfalls founders and early-stage investors should be aware of, while some others will be discussed in later Chapters:

Participating Liquidation Preferences

While we describe liquidation preferences more fully later (see under Chapter A.III.6.3), we want to note that these provisions create a waterfall of distribution and give investors a first claim on liquidation and exit proceeds in preference to the holders of common shares (*i.e.*, usually the founders or beneficiaries under an employee stock option plan). When looking at the economic ownership of a start-up, one variation of the liquidation preferences is of particular relevance, the (fully or capped) participating liquidation preference (*nicht anrechenbarer Erlösvorzug*). As we will see, participating liquidation preferences give the investors a real preference without the founders getting a chance to catch up on the next level in the distribution waterfall.

8 We looked at a number of the VC deals that our European offices advised on during 2020 and summarized our findings and some trend predictions in our Deal Term Review 2020, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/2021/orrick-deal-flow-2020.pdf.

While liquidation preferences do not seem to matter a great deal in early rounds with smaller investment amounts, inappropriate liquidation preferences can haunt a start-up and its founders forever.

If angel investors request a participating liquidation preference (in the current environment, such requests are rare and should give every founder reason to pause, unless we are talking about downround/distressed financings) for their often relatively small investment amounts, they should be aware that this will set the tone for liquidation preferences that later-stage investors will request for their then often much larger investment amounts. Sooner or later every founder with basic math skills and a spreadsheet calculator will figure out that with several layers of uncapped fully participating liquidation preferences, her participation in the company – although it might still look impressive on paper – will be worth little except in case of a really big exit. This might have a devastating effect on her motivation, in particular when the company does not scale as anticipated or a pivot is called for, you know, just those situations when you as an investor really want your founder team to be fully motivated. This situation can get so bad that investors sometimes feel compelled to introduce another preference level in the waterfall immediately prior to the last level of *pro rata* participation to give the founders a certain preference (sometimes called a "founders carve-out" or "founders catch-up").

We are big fans of "upside optimization": *pro rata* rights are important; liquidation preferences, anti-dilution and reps and warranties less so. In the end the trust and happiness of the founders are 10x more important for the investment outcome than a maximum of investor rights when things go awry.

[*Elias Börgmann-Dehina*, General Counsel at Headline Ventures]

In addition, some liquidation preferences come in the form of stacked preferences, *i.e.*, the liquidation preferences of later-stage investors rank senior to the ones agreed upon in earlier rounds (in the current market environment we tend to see more often *pari passu* liquidation preferences, *i.e.*, all liquidation preferences are on the same level, but stacked ones are not that uncommon). While an early investor might think it is negotiating a great deal when pushing down the founders' throat a participating liquidation preference, that investor might well end up looking like a holder of common shares in terms of return when one assumes that terms of later-stage financing rounds are often inherited from the early rounds.

So, it should be in both early investors' and founders' best interest to keep it lightweight and simple in the very first rounds, *i.e.*, no liquidation preference at all, or if the investor insists on some kind of liquidation preference (as she will often do), a 1x non-participating liquidation preference (for details see Chapter A.III.6.3).

Excessive Preemption Rights on New Shares / Super *Pro Rata*

If the company makes any future share offering, existing shareholders (at least existing investors) will require the right to maintain at least their percentage stake in the company by participating in the new offering, up to the amount of their *pro rata* holding, under the same terms and conditions as the shares are offered to new outside investors. This appears to be fair enough, as such preemption right is automatically provided for by law in Germany, although it can be waived, and it is customary to agree on certain exemptions in the shareholders' agreement (*e.g.*, for shares issued under an equity-based employment stock option plan or in the course of an antidilution capital increase or a compensatory capital increase (we will come back to all of this in a little while) or when the company's advisory board with the majority of the investor representatives request such waiver).

Some investors might demand what is called a super *pro rata*, be it in the form of a certain multiple of their *pro rata* preemption right or the right to invest at least a certain EUR amount in the next financing round even if such amount will exceed its *pro rata* entitlement. Sometimes, investors even ask for a right to preempt the entire financing round and acquire 100% of the new shares to be issued in a subsequent financing round.

However, founders should tread carefully. The existing shareholders and new investors or the company may have different interests. Founders and the company often want the maximum degree of freedom to make space for new investors and have the ability to finance around dissident existing investors, while existing investors will want to maintain their ownership percentage as well as related economics and control rights and, ultimately, the ability to block an undesired new investor. We think that in most cases a simple *pro rata* subscription right with the above-mentioned exceptions should be an adequate compromise (especially if one keeps in mind that capital increases will often require an investor majority anyhow). In addition, in order not to unduly impede future financing rounds, all shareholders should commit to waive their preemption rights if certain criteria are met, in particular when a new investor stands ready to invest in the company and an investor majority (for details see below under Chapter A.IV.1.3) (or their representatives on the company's advisory board) requests such a waiver.

OUR (CURRENT) LIST OF THE
10 MOST COMMON
EARLY ROUND MISTAKES

FOUNDER TEAM AND SET-UP

#1: Not thinking about founder team dynamics and founder departures.

#2: Defaulting to an even share split amongst founders without having that awkward discussion first.

#3: Being weak on the most important quality in the early stages – hiring really great people and telling a compelling story.

GENERAL SET-UP

#4: Not investing via personal holding entities.

#5: Not having an adequate employee participation program or having one that is not understood.

EARLY ROUNDS FINANCING

#6: Giving away too much equity too early.

#7: Not understanding that while the right angels can make a company, the opposite is equally true.

#8: Seeing your board primarily as a control function.

#9: Not thinking about your cap table composition over multiple financing rounds.

#10: Having a poor share/stakeholder management when negotiating financing rounds.

Pay-to-Play Provisions – When do they Make Sense?

If early-stage investors insist on certain veto and preference rights, a pay-to-play provision is one way to mitigate the negative consequences for future financing rounds and avoid the risk that relatively small investors might engage in obstructive rent-seeking behavior or ultimately hold the company hostage. Pay-to-play is a provision which requires an existing investor to participate in subsequent financing rounds (pay) in order not to forfeit certain rights (keep playing), such as antidilution protection, veto rights or the right to appoint members of the advisory board. Pay-to-play provisions come in different levels of intensity, *e.g.*, softer versions do not require an investor to forfeit its preferred rights forever but reinstall them if the investor subscribes for its *pro rata* portion of new

shares in any of the next financing rounds. Although the latter might be preferable from the perspective of the respective investor, it can make future financing rounds more complex when there are reemerging legacy provisions to take care of.

While there is a general argument for pay-to-play provisions, as they require the investor to stand up at the time of its initial investment and economically commit itself to support the company through its life cycle, pay-to-play provisions have in recent years become relatively rare. They need to be squared with the dynamics of the existing and potential future investors. Adding a pay-to-play provision in a later-stage financing round with new investors can be difficult to implement. In this case, adding a pay-to-play could be understood as a signal that existing investors will not be willing to support the company in future financing rounds, thus the need for a pay-to-play. The incoming later-stage investor will often reject them given that for such an investor the risk of a down round will be highest and a pay-to-play provision will for this investor put its antidilution protection at risk. On the other hand, pay-to-play provisions may be inappropriate in very early rounds when the early-stage investors are angels or micro venture capital investors that cannot be expected to participate in future financing rounds. Requesting a pay-to-play would penalize these very first backers of a company who bear the most risks. Our general advice is to be careful with preference rights for very early-stage investors and to compensate them for their higher risks more through an appropriate valuation of the company than through too many preference rights.

When drafting the pay-to-play, one must also consider its interplay with the aforesaid preemption rights. As explained above, it is generally advisable to have provisions in the financing documentation that allow a(n) (investor) majority to waive the existing shareholders' subscription rights, such as when the company is doing well and a new investor wants to acquire a significant stake in the company. If the preemption right is waived by an investor majority with effect for all shareholders, this should also apply to the pay-to-play requirement, as existing shareholders are effectively excluded from the financing round.

4. TYPES OF FINANCING

4.1 The Financing Process

From Pre-Seed to Post-IPO

"Begin with the end in mind" is what personal development legend *Stephen R. Covey* advised his readers in his classic '7 Habits of Highly Effective People'. For many founders this might mean smiling into the cameras after they rung the bell on the day of their company's IPO or a sale to a multinational corporate for a sum that would make their former classmates blush. Such a successful exit was preceded by years of rapid and of course exponential growth and this growth was fueled by VCs and growth investors through a couple of increasingly larger financing rounds at higher valuation points. But before VCs get on the roller coaster, the start-up has survived the early years often because business angels, *i.e.*, usually the real risk takers amongst the investor class, have supported the initial humble beginnings.

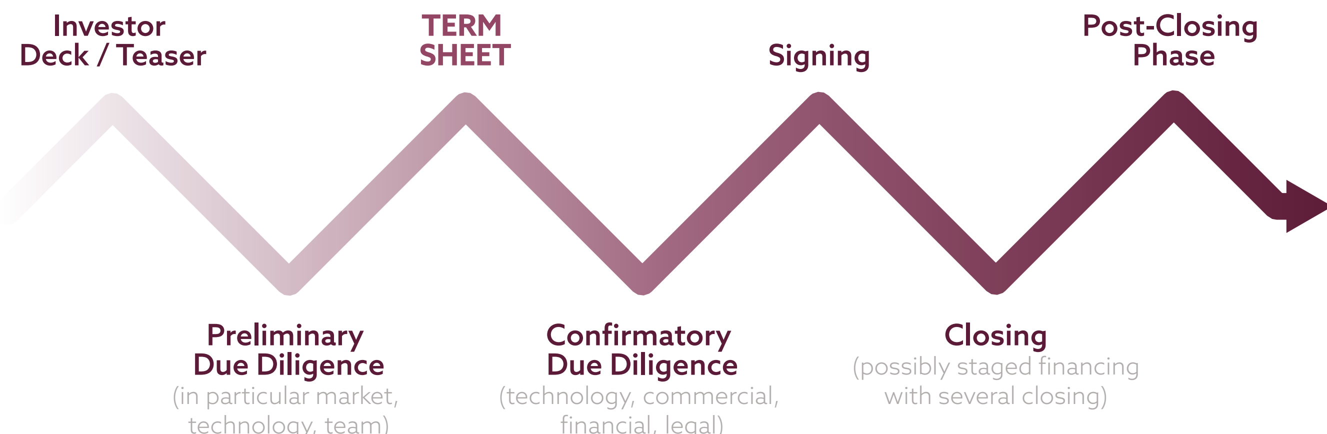
While there are certainly admirable exceptions of founders who made it without ever taking investors' money, the majority of successful start-ups have engaged in many efforts to raise capital through rounds of external funding. These financing rounds used to be labelled with the letters of the alphabet starting with the Series A, followed by Series B and Series C and so on. Over time business angels became more professional and some VCs started to invest smaller tickets in earlier stages of the company's life cycle. Introduce the Seed Round, when a new tree is planted that given enough dedication, water (read more funding and hopefully revenues) and light (read growth) will turn into a mighty money tree. These days, in many segments Seed Rounds have become quite sizeable too so that ever creative founders came up with a new name for their first fund raising, the Pre-Seed Round so that they could save the label Seed Round for the next hopefully more sizable financing round. At the risk of grossly oversimplifying the nuances and variety of "the real start-up life" (might be a good title for a reality show, come to think of it...), a company's funding life cycle can be summarized as follows.

Stage/Round	Investors	Size	Use of Proceeds
BOOT STRAPPING	Own resources, sometimes friends and family (great, every family gathering will be an investor meeting, yeah, we all have that very special uncle)	Usually a couple of tens of thousands (depends a bit on your family and network of friends and whether you come straight out of university)	Tinkering and playing around with the foggy idea that someday is supposed to be a viable product or service
PRE-SEED	Business angels, occasionally micro VCs, incubators and accelerator programs	Couple of hundred thousands	Getting the company off the ground with a focus on the technological proof of concept and evaluating the potential future market (occasionally, paying your lawyers for the first time)
SEED	See investors of the Series Pre-Seed plus increasingly (early stage) VCs	Often between EUR 500,000 – EUR 2,000,000	More of what has been done in the Pre-Seed phase. At this point, there is often an MVP and a first trial launch with test customers
SERIES A	VCs	Often between EUR 5,000,000 and EUR 10,000,000	Grow user/customer base, drive first sales and revenue growth, potentially enter into new markets and scale the team with additional key hires that can grow a start-up beyond the development phase
SERIES B AND BEYOND	(later stage) VCs, and given the lower perceived additional investors such as CVCs, early stage private equity investors, sovereign wealth funds	Often around EUR 15,000,000 to EUR 40,000,000 and sometimes much more for the Series B and depending on the company's success, these days Series C and beyond can be nine digit EUR amounts	Growth, growth and growth

But let us repeat this. The above is a strong simplification and the path for each start-up will be more or less unique, as is the timeline for funding. In the media you will usually read about the lucky few who will bypass some of the rounds or raise much more capital much quicker (particularly those start-ups with blockbuster ideas that at such point in time are seen by the investors as truly revolutionary or those attached to serial entrepreneurs with successful exits under their belt).

The Funding Process

The following is a simplified overview of the different stages of a typical funding process.



- Investor Deck/Teaser: Obviously, having wooed an investor helps with the funding process. So first thing is to identify what kind of investor would be best suited for your business idea. In addition to funding, founders should especially in the early stages of their start-up look really carefully for the famous "smart" money, *i.e.*, understand what additional benefits the investor can bring to the table, be it access to networks of top hire, future investors or business partners, mentoring or special technical expertise or domain know-how. Founders will also need to understand what time commitment they can realistically expect from their prospective investor and what impact that will have on the likelihood that the investor will actually deliver on its promises to add value beyond the liquidity injection.

  In order to get the discussions rolling, having the key highlights of your start-up neatly presented in a polished short teaser document (backed up by a longer and more detailed pitch deck) is key.

ONE THING A FOUNDER SHOULD NOT ASK HER PROSPECTIVE INVESTOR

Well, that question is obviously a bait, there are quite a few questions that can irritate any prospective angel or VC investor. But just because we get this asked all the time: You should NOT ask an angel or VC to sign a non-disclosure agreement (usually just referred to as an NDA). But doesn't that mean that they can steal my idea? You might wonder. The answer is "yes", but still. Asking for an NDA is a waste of time and it will be counterproductive or at least slow down your fundraising. Most investors will either refuse or assume that you are unsophisticated for even asking. It's hard enough to get an investor interested and these investors are in the business of searching for and evaluating tons of business ideas and businesses and don't want to be hamstringed by a non-disclosure obligation that might prevent them from using what they learned on the way. For the most part, it's not the idea that is important; it's the implementation of the idea, progress in executing the idea, and the expertise of the entrepreneurs behind it. Note (yes, we still are lawyers…), that in some cases when letting a corporate investor do some due diligence on your company, the situation might be different.

- Preliminary Due Diligence: After a first contact has been established, a preliminary review of the start-up usually takes place. The potential investor will seek to understand if there is a real opportunity. The focus here is not so much on whether the founders can actually pull it off but more on how big this could be. The founders' track record, domain expertise, team set-up and execution muscle are examined thereafter. At this stage, the parties will also have a preliminary discussion on numbers, notably the potential investment amount and a valuation range for the company.
- Term Sheet: Assuming a satisfactory outcome of the preliminary due diligence, the potential investor will usually put forward a draft term sheet to sketch out the main elements of the investment and the future relationship amongst the company's shareholders. Although the term sheet is not legally binding, it sets the course for the entire round and the parties will be expected to stick to its terms. We discuss the term sheet in a bit more detail in Chapter A.II.6.1.
- Confirmatory Due Diligence: Once a term sheet has been concluded, the investor will engage in a confirmatory due diligence. While the lawyers will work on the lengthy transaction paperwork (turning a 3+ pages term sheet into a 80+ pages agreement is an art that should command more respect), the investor and its advisors will have a closer look at the economic, legal, tax-related and financial situation of the company. We have summarized the typical legal topics an investor will review below under Chapter A.II.5.

- Signing: Finally, the big day has arrived, the documentation gets signed, and money is flowing into the company's coffers. Well, not so fast. While our US and UK colleagues will just circulate a set of signature pages for digital signature and then have the company's counsel prepare a closing set, in Germany the investment documentation will usually need to be notarized, *i.e.*, read out aloud in front of a notary (yes, all of it). Keep in mind that powers-of-attorneys for investors subscribing for newly issued shares require notarization and if they are notarized outside of Germany in addition an apostille or in some countries a legalization is required (and don't forget certificates of representation and certificates of good standing, as the case may be), and you will understand that in particular with incoming foreign investors, preparing the signing date can take quite some time.

  Also, unlike in the USA and the UK, in Germany the signing will usually not coincide with the closing, *i.e.*, when the investor pays the (entire) investment amount for its newly issued shares. We will come back to the reasons for this staged signing and closing process (see under Chapter A.II.6.). Suffice it to say that the shares the investor will acquire in the financing round will first need to be created via a capital increase which in turn needs to be registered with the start-up's commercial register and that process can sometimes take up to several weeks.

- Closing: "Closing" refers to the moment when the company actually receives the full investment amount; or to be more precise: in Germany, closing is often defined as the point in time when the capital increase that creates the new shares is registered with the company's commercial register and the investor will acquire its shares which in turn will obligate the investor to pay the (bulk of its) investment amount within a reasonably short period of time of usually between five to ten business days.

KEEP THIS NOTIFICATION REQUIREMENT IN MIND WHEN RECEIVING VC FUNDING FROM ABROAD

After closing of the investment I am done with regulatory issues, right? Not quite yet! There are payment reporting obligations that the start-up might have *vis-à-vis* the German Bundesbank. For example, if an amount of more than EUR 12,500 is transferred to or from abroad – say from a US VC, this transfer must be reported. Please be also aware of the fact that not only cash or bank transactions might be considered but also contribution of property or rights. More details can be found, and filings can be made here: https://www.bundesbank.de/en/service/reporting-systems/external-sector.

4.2 Convertible Loans

While in the remainder of this Guide we will focus on equity financings, *i.e.*, the issuance of new preferred shares to investors against cash contribution, in this and the next Chapter we want to briefly present convertible loans and venture debt as two further important start-up financing options.

What it is and when to use it

Let us begin with the convertible loans as they are the more important financing tool in start-up land, especially in the early stages. In a nutshell: a convertible loan is a loan granted by an investor to a start-up which, however, generally is not designated to be repaid. Rather, the lender shall at a later stage convert her repayment claim (as well as her claim for payment of accrued interest, if any) into an equity participation in the borrowing start-up. Accordingly, convertible loans belong to the group of mezzanine or hybrid financing instruments, *i.e.*, initially they are treated as customary debt financing but, depending on the specifics of the case at hand, can or even shall later on be converted into equity.

Due to, among other things, their flexibility in possible scope of use, convertible loans are an important part of the financing portfolio of a start-up. In this respect, convertible loans are generally not tied to certain stages of the life circle of the borrower. Although convertible loans in practice are mainly used in connection with the financing of start-ups in their very early stages, they are also used at growing companies in later stages. Convertible loans have become increasingly important in recent years.

Convertible loan make a lot of sense in the really early phases. They are fast, cheap and let the founders concentrate on the only thing they should care about: getting their start-up off the ground.

Especially in the very early stages of a start-up, a convertible loan can be a sensible preliminary stage to a first equity financing round (as we have seen, the so-called Series Seed or the Series Pre-Seed). With relatively straight forward and easy to implement agreements, a first financing can be made available on short notice and with little effort to the start-up for the further development of the start-up's business model. In this context, the *German Standards Setting Institute* (an initiative of the federal association of German start-ups (*Bundesverband Deutsche Start-ups*) and of the Business Angels Network Germany (*BAND*)) issued a first template agreement for (straight forward) convertible loans in the summer of 2018, which has already achieved some popularity.

However, also in later stages of a start-up convertible loans can be issued; in these cases convertible loans are often used to bridge the financing needs of a start-up immediately prior to an imminent next (equity) financing round (which is usually envisaged to happen within the next three to six months), or in preparation of an exit.

Convertible Loan Check List

While in another edition of the OLNS[9] we go deep on the key commercial and legal terms of convertible loans, we limit ourselves here to a checklist of the material issues that founders and their investors should think through:

Parties	• In case of bilateral convertible loan agreements, *i.e.*, loan agreements concluded solely between the borrower and the lender, the lender might want to request a notarized authorization resolution of the shareholders' meeting. • The existing shareholders should undertake, either in the convertible loan agreement itself (we call these loan agreements to which not only the borrower and the lender but also all existing shareholders of the borrower become parties "multilateral loan agreements") or, in case of a bilateral loan agreement, by concluding a separate agreement in the form of a genuine contract for the benefit of third parties (*echter Vertrag zu Gunsten Dritter*) outside the loan agreement, to ensure that any third parties becoming shareholders of the company in the meantime also assume the cooperation obligations pursuant to the convertible loan agreement (in particular, with regard to the implementation of the conversion). • In case there is more than one lender, it should be specified that they are not jointly and severally liable and that their claims rank *pari passu*.
Loan Utilization and Purpose	• Shall there be specifications and limitations for the use of the loan amount? The lender will often try to limit the risk of a distribution or other pay-out of funds to the existing shareholders. • In case the payments are linked to the achievement of milestones, the milestones should on the one hand be worded in such a way that they can be objectively verified and on the other hand do not deprive the borrower of the necessary flexibility in the further development of the business.
Interest	• How will the loan interest be structured (interest rate, calculation method and, as the case may be, provisions regarding the capitalization of interest)? • In the current environment, we frequently see interest rates between 3 to 6% p.a. Interest rates came somewhat down in the recent years given the relatively wide availability of early-stage financing in many sectors. Note that from an economic (dilution) perspective the discount and in particular the cap on the conversion price (if any) are usually more important than the interest rate. • Shall interest accrue in any case or only if the loan is not converted within a certain period after being granted?
Term	• Is the term appropriate considering the purpose of the loan (merely a bridge loan or loan with longer term financing character)? • In case of pure bridge loans, the term is often six months, in other cases it is usually between 12 to 24 months, rarely longer. • During the term, the possibility of ordinary termination (*i.e.*, termination other than for cause) shall be excluded. Any early repayments should require the lender's prior approval.
Subordination	• In any case, the convertible loan agreement should contain a properly worded qualified subordination clause. • When drafting the subordination clause, it is important to ensure that such subordination does not unintentionally qualify as waiver and, thus, triggers negative tax consequences.
Conversion Event	• The convertible loan agreement should precisely specify when the lender shall be entitled or even obliged to convert the loan. • Typical conversion events are the next qualified financing round and the expiration of the term of the convertible loan (maturity date conversion). Sometimes, an exit before the end of the term also qualifies as a conversion event. In such case, however, the parties should carefully consider if, in order to avoid further complexity in the exit process, the lender should, for the sake of simplicity, be entitled to a one-off compensation claim against the borrower in lieu of a conversion of the loan into shares (which would then need to be sold to the acquirer immediately thereafter). • Qualified financing rounds usually require a certain minimum investment amount and sometimes a minimum pre-money valuation for the financing round is stipulated as well. The requirements of a qualified financing round should be defined precisely. This particularly includes for example whether the financing round must also include new investors and that actually only "fresh money" is taken into account when determining the size of the financing round.

9 See our Guide OLNS#2 – Convertible Loans for Tech Companies, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/olns-02-convertible-loans.pdf.

Number of New Shares	• The convertible loan agreement should precisely specify which conversion amount may be converted at which conversion price. This constitutes the basis for the determination of the number of new shares to be issued to the lender. • For the conversion amount it is, *inter alia*, decisive whether the loan amount accrues interest and if so whether the accrued interest shall be converted or paid in cash (conversion is standard). • The conversion price usually differs according to the conversion event: ‣ For a conversion at expiration of term (maturity date conversion), the conversion price should already be fixed when entering into the loan agreement. ‣ For a conversion in the context of a qualified financing round, the conversion price is usually based on the pre-money valuation of the qualified financing round, provided that usually a discount between 10% and 20% is applied and that the maximum valuation is capped at a certain amount. In relatively few cases, the parties also agree on a minimum valuation (floor) to determine the conversion price. ‣ In cases where an exit event (in particular sale of the borrower or the majority of its assets) prior to expiration of the loan term shall trigger a conversion, the conversion price is often derived from the exit valuation minus a certain discount (often 10%-20%). However, as already mentioned above, often the loan agreement will foresee a certain special cash payment (frequently 1-2x of the outstanding principal) on top of the repayment of the loan in case of an exit rather than a conversion.
Implementation of the Conversion	• The conversion should be executed in form of a capital increase in cash against the issuance of new shares at par value (*i.e.*, EUR 1.00 for shares with a nominal value of EUR 1.00). The repayment claim will be assigned and contributed into the capital reserve of the borrower subject to the condition precedent that the capital increase is registered (in case of a conversion in the course of a qualified financing round, the assignment should be made subject to the borrower having received an amount of the fresh money injection at least equal to the assigned loan amount to avoid potential tax issues). • Either the convertible loan agreement itself contains provisions which obligate the existing shareholders to implement the capital increase and waive their otherwise existing subscription rights (recommendable in the case of multilateral agreements) or such provisions are provided for outside the loan agreement in a corresponding authorization resolution of the shareholders' meeting of the borrower.
Shareholders' Agreement and Pooling	• Should a provision be included according to which the lender shall accede to a shareholders' agreement existing, newly concluded or amended, as the case may be, in the context of the qualified financing round (attention, this may result in a notarization requirement with respect to the convertible loan, see below)? • In case the borrower has taken out multiple (smaller) convertible loans, a provision may be advisable, which in the event of conversion, obligate the lenders to pool their (micro) shareholdings and to grant voting power to the pool leader.
Information and Monitoring Rights	• Which information rights should the lender have and which regular reports should the borrower provide? • Should specific actions and measures of the borrower be subject to the prior consent by the lender?
Representations	• Should the borrower grant certain representations (in practice, this is relatively rare these days) and, if so, what legal consequences should apply in the event of a breach of such representations (compensation in cash or by issuance of new shares (compensating capital increase))?

Other Provisions	• The loan agreement should provide for a general prohibition of assignment with customary exemptions. • Should the borrower be restricted in raising further (convertible) debt? • Should the convertible loan agreement include a so-called "most favored-nation clause" in case convertible loans are drawn by the borrower in the future providing for more favorable conditions for future investors? • Sometimes the lender requests a subscription right to participate in the conversion round (to keep its *pro rata* or with a certain amount). • In case a flip of the borrower is a realistic option in the near future, then the convertible loan agreement may also provide for an obligation of the lender to "replace" its convertible loan concluded with the borrower by an economically equivalent instrument with the new parent company of the borrower (US HoldCo).
Is a Notarization Required?	• Bilateral loan agreements (*i.e.*, agreement entered into only between borrower and lender) are not subject to a notarization requirement; however, the underlying authorization resolution of the shareholders' meeting might arguably require notarization (according to a partially represented opinion, the resolution shall require both notarization and registration). • With respect to multilateral agreements (*i.e.*, all existing shareholders become party to the convertible loan agreement) the following applies: ‣ If the loan agreement does not foresee that the lender can be requested by the borrower to convert its loan (note that this concept of "voluntary conversion only" should be carefully thought through as it may have implications for future financing rounds), a notarization of the loan agreement should not be required. ‣ Notarization is, however required, if the lender can be forced to convert its loan and if the convertible loan agreement obliges the borrower to accede to a shareholders' agreement upon conversion that itself contains provisions that require notarization (in particular obligations to co-sell, drag long rights, etc.).

4.3 Venture Debt

For emerging technology companies, gaining access to financial resources is a key challenge. Traditional bank loans are often unavailable, and the financial means of the founders are usually limited. A(n) (equity) financing by VCs often represents the most expensive form of capital. As we will see, together with the customary investor preference rights, VC funding dilutes the founders' economic interest in the company and to some extent, shifts control over the start-up to the investors.

While we cannot go into a lot of detail here, we want to point out that for some (though usually not early-stage) start-ups venture debt or venture loans may offer cheaper money without the dilutive effect of another (equity) financing round[10].

In a nutshell, venture debt loans are mid-term financial debt instruments targeted towards the specific needs of high-growth young technology companies which have already secured (previously or at least simultaneously) the backing of institutional VC investors. Venture debt loans are usually amortizing (although we also see bullet repayments) and frequently feature interest-only periods of anywhere from six months to eighteen months. In any case, given that the German market for venture debt loans is still relatively small and new, it offers a lot of flexibility for start-ups and provides the opportunity to negotiate a tailor-made instrument.

> Venture debt needs to be repaid and it will add another stakeholder with differing interests that needs to be taken care of. That being said, it can be an attractive and increasingly cheaper financing form when growing into higher valuations for the next equity raise.

10 For more details on the pros and cons of venture debt and the most important commercial and legal terms, see our Guide *OLNS#1 – Venture Debt for Tech Companies*, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/o/onls-01-venture-debt-for-tech-companies.pdf.

But why is venture debt attractive to a lender? Does it make sense from a credit risk perspective? Some commentators have pointed out what they call the "puzzle of venture debt". According to conventional wisdom, debt and start-ups are not supposed to mix. Why would venture debt providers lend money to nascent companies with a promising but ultimately uncertain future and in most cases still negative cash flows/EBITDA and usually very little tangible collateral? Yes, start-ups may have intangible assets in the form of intellectual property rights. However, liens on such intangible assets are often difficult to enforce and the realizable value is usually limited. But venture debt loans do not mean equity risks for a "normal" debt return as Venture Loan providers seek to reduce their risk exposure through:

- due diligence;
- selection of start-ups with a "suitable" cap table; and
- more or less broad contractual covenants.

In addition, interest rates on venture debt loans are significantly higher when compared to traditional bank loans. On top of that, often a variety of fees and charges is added to juice up the lender's returns. Often, an equity kicker in the form of a warrant, exit payment or otherwise gives the lender an additional upside.

Despite this equity kicker, venture debt loans should not be confused with convertible loans. As we have seen, convertible loans are equity-like instruments. They are economically designed as "loans to own", *i.e.*, designed ultimately to fully convert into equity so that the lender becomes a shareholder in the start-up. Venture debt loans on the other hand are meant to be paid back and do not convert into equity (except for the equity kicker).

SOURCES OF INCOME FOR LENDER	PRINCIPAL & INTEREST	FEES	EQUITY KICKER & EXIT INCENTIVES	
VENTURE DEBT				
MITIGATION OF RISKS FOR LENDER	EXISTING VC INVESTORS	CPS & AMORTIZATION, (INCL. MANDATORY EARLY REPAYMENTS)	MONITORING & COVENANTS	COLLATERAL

5. INVESTOR DUE DILIGENCE AND REGULATORY ISSUES FOR CERTAIN TECH INVESTMENTS

5.1 What Investors and their Lawyers Want to See

Once the parties have agreed on the key terms of the transaction – usually by signing a term sheet – the investor will undertake a confirmatory due diligence on the company, at this point usually including legal, financial, and tax (assuming that the commercial and market due diligence has already been addressed by the investor in its preliminary due diligence leading up to the execution of a term sheet, otherwise in this confirmatory phase the investor may undertake additional market and commercial due diligence as well).

For these purposes, the investor and its advisors will provide the company with a list of documents and information that they would like to receive under each area which they intend to cover in their respective due diligence inquiry. This is often called a document request list or a due diligence questionnaire.

The due diligence process can take a couple of days to a few weeks and may prove to be a real burden on the day-to-day operations of start-ups. Founders are well advised to be prepared for the investor's due diligence when they hit the fundraising trail and to have all relevant information on hand in a structured and comprehensive manner.

Here are some of the topics that investors will usually want to examine in their legal due diligence, although the scope and depth will depend on the stage of the company, as well as the size of the investment.[11]

Corporate

- General information, including:
  - Current excerpts from the commercial register;
  - Complete founding documentation (*Gründungsdokumentation*);
  - Corporate bodies and information on organization and reporting regulations, including any rules of procedure; and
  - Minutes of any meetings of corporate bodies.
- Shareholders and shares:
  - Complete chain of title since the incorporation;
  - Information on any rights and encumbrances on shares;
  - Information on any capital-related measures;
  - Information on special privileges granted to any shareholder; and
  - Declarations and agreements regarding contributions to be made by shareholders (*e.g.*, media-for-equity).
- All agreements regarding shareholder loans and shareholder securities as well as convertibles and warrants;
- Information on the sale/acquisition of any participation or interest in other entities; and
- Information on controlling, reporting and compliance systems.

Finance and Taxes

- Information regarding bank accounts, balances and income statements;
- Information on the financing of the company including its historic and current burn rate as well as if applicable venture debt financings;
- (Financial) leasing agreements;
- Subsidies and other forms of state aids (including applications);
- Tax returns, statements and assessments; and
- Financial plans and budgets.

[11] Sometimes, especially in case of later-stage companies, other matters, such as insurances, product safety, real estate regulatory and (trade) compliance, can also be part of the investor due diligence.

Intellectual Property Rights

- Information on all patents, trademarks, copyrights, registered designs, other intellectual property rights, domain-names and know-how, which are used and/or owned/in-licensed by the company;
- Description mapping the company's key intellectual property rights and know-how to the company's products/services or specific components thereof;
- Agreements regarding the transfer of any intellectual property rights or know-how from the company to a third-party (including founders, shareholders and employees) or vice versa;
- Description of how the company manages its intellectual property (*e.g.*, how potentially patentable inventions are identified, how the company manages deadlines and the payment for renewal fees for registered intellectual property rights, whether the company works with external IP counsel);
- Description of how the company protects its know-how (*e.g.*, IT security measures, access restrictions, use of non-disclosure agreements);
- Inbound and outbound license agreements with third parties regarding intellectual property rights or know-how;
- Non-disclosure agreements with third parties;
- Agreements regarding other intangible rights (*e.g.*, agreements about software utilization, web-hosting agreements and naming rights);
- Information about any past, present or imminent future issues and disputes regarding the ownership, validity or infringement of intellectual property rights or know-how (*e.g.*, warning letters sent to, or received from, third parties, pending nullity oppositions or nullity actions, infringement actions), including all related correspondence and documentation;
- Detailed information on the use of any open source software;
- If needed for the valuation of the company's IP rights, the investor will request further documents and information on a product or service, such as:
  - Product/service definition;
  - Product/service documentation;
  - Overview of procedures and processes;
  - Logical and physical architecture of the products/services; and
  - Code review.

Data Protection

- Description of the existing measures and structures of the company to safeguard compliance (internal and external) with data protection regulations (including documentation regarding data protection guidelines, privacy agreements with third parties, data security guidelines, etc.);
- Comprehensive report on status of preparation for the EU General Data Protection Regulation (GDPR) and the EU ePrivacy Regulation; in particular if the company's core business is to process personal data, one should review reports on how the software/operations do comply with the new European requirements; if the company develops and sells software that allows customers to process personal data, one should request a report on how such software complies with the principles of data privacy by design and by default;
- Data privacy notices for customers and employees;
- Information about the data protection officer (if appointed) including yearly data protection report of the data protection officer;
- (Standard) data processing agreements (*Auftragsverarbeitungsverträge*) of the company, *e.g.*, for customers/for employees, if necessary, for different legal systems, as well as correspondence with the local advisors for the implementation of such agreements;
- Data processing agreements entered into between the company and third-party providers; and
- List of all past data protection violations and complaints.

Employment

- (Anonymized) list of all employees (including executive employees and managing directors), including information regarding age, entrance date, function, gross salary and other specific information (*e.g.*, parental leave, disability, etc.);
- Examples of employment and service agreements as well as consulting/service agreements with freelancers;
- Collective agreements, internal regulations and policies;
- Information on any employee representative body (*e.g.*, works council);
- Reports about any review of the company by public authorities (especially social security agencies); and
- Information about any employee health service regulation compliance.

Material Agreements

- Agreements with major suppliers and customers;
- Agreements with agents, multipliers, influencers, etc.;
- Material lease agreements;
- Non-compete/nondisclosure/territorial protection agreements;
- Agreements with an unusual notice period or with an exceptional value; and
- Agreements with exclusivity clauses or clauses related to territory, contract partner, resale prices, further product utilization, etc.

Litigation

- Information on legal disputes (pending and threatened).

5.2 Let's get Legal – Some Deals might Trigger Regulatory Scrutiny

Don't regulatory aspects only need to be considered when we are talking about M&A deals? Actually, no, they can also come into play in the arena of start-up financing. We would not be surprised if "You cannot be serious!" is your reaction now (and not only on tennis courts in the 1980s[12]).

> Seriously, you are about to read the most sophisticated and valuable section of this OLNS edition (not only from a legal perspective). Ok, the authors of this section have to admit that this is rather a teaser for one of the next editions of OLNS which will be dealing with regulatory issues of tech transactions and cross-border start-up investments—and will be truly awesome, don't miss it!

So, while you will have to wait for the coming masterpiece, in this Guide, we want to provide a very brief overview of the most important regulatory aspects that can come up in German VC deals, namely merger control and foreign direct investment control. These are – in all seriousness – important issues and although there is admittedly rather little to win with these topics, there is a whole lot to lose when not properly dealt with. "To lose" is to be taken quite literally: security of the transaction (possible sanction: invalid transfer of shares or assets), money (significant fines), or freedom (imprisonment). Still "a moo point"[13] for you or caught your interest?

12 For post generation Y readers: *John McEnroe* was pretty convincing with this slogan. John, who?

13 See *Joseph Francis Tribbiani Jr.* (Friends): "This is all a moo point. It's like a cow's opinion. It just doesn't matter. It's moo."

Merger Control

Merger control refers to a regulatory review of a transaction from a competitive and antitrust perspective. In a first step, you need to analyze if a transaction is notifiable under any merger control regime worldwide (currently, there are more than 130 jurisdictions with merger control rules).

The vast majority of merger control proceedings only apply in case certain turnover thresholds are triggered (*e.g.*, in Germany, EUR 500 million, EUR 50 million, and EUR 17.5 million – these thresholds need to be triggered by one or more undertakings involved[14], worldwide or in Germany only, etc. – but don't waste your time with this, we will let you know about the specific requirements your start-up needs to deal with). However, even if the revenue thresholds are missed, an investment might still be notifiable as there are certain other triggers that must be taken into account as well, *e.g.*, market shares (you may wonder what's the relevant market?[15]), assets, or the value of the transaction. This is in particular true for the tech sector as tech companies recently faced some clampdown by authorities.

Let's look at the German merger control regime as an example:

- You might wonder "Why bother? My start-up is all about the future and right now, we generate very low or not even any turnover in Germany." Well, because German law no longer only looks at revenues but introduced another trigger relating to the so-called value of transaction of the proposed deal a couple of years ago.

Interested in German merger control history? Then imagine the atmosphere at the Federal Cartel Office when Facebook announced its USD 19 billion acquisition of WhatsApp in 2014 and the officials realized that German turnover thresholds are not triggered despite the small number of 33 million WhatsApp users in Germany in those days already. (BigMac complaining about a ball being on the line is probably nothing compared to what happened in Bonn that day). The starting point of the value of transaction threshold...

- If you are a unicorn, decacorn, hectocorn, or dragon, your deal could easily exceed a transaction value of EUR 400 million and you need to carry on with an analysis of *inter alia* turnover of the investors or "substantial domestic operations". Sounds vague? It is! Although there is some limited guidance from the authorities it really depends on a case-by-case analysis of the deal whether this applies to your specific investment case.
- Thus, are we good if (i) the parties involved in the deal do not trigger certain turnover thresholds, and (ii) the deal does not exceed EUR 400 million value of transaction? In the good old times, the answer would have been yes... But in 2021, there is a risk that the deal is referred to the European Commission as the competent merger control authority even if the thresholds in Germany (or other EU Member States) are not triggered. FYI: This is really new, and we will follow up closely on how this is dealt with in practice.

14 What the hell is an "undertaking involved?"

15 Some of our friend's co-authors might add here: "sure, if you have no life or start-up to build..."

- If any threshold of the above is triggered, then you need to move on with the analysis if your investment deal is a "concentration" within the meaning of the merger control regime. This depends on whether the investor will get any control (sole, joint, negative?) over the start-up, acquires a specific number of shares (*e.g.*, more than 25% of the share capital), or a so-called significant competitive influence. Significant competitive… what? This sounds pretty vague! Again true…

Foreign Direct Investment Control

Foreign direct investment control refers to another regulatory review. And before you ask, yes, this review can be on top of the national and EU merger control reviews as explained above so you might have the pleasure to have two separate types of closing conditions: one for merger control and another one for foreign direct investment control[16]. However, no need to worry that this is getting boring as there are usually other authorities involved (in Germany the Federal Ministry for Economic Affairs and Energy) and the scope is different from merger control review, *i.e.*, in Germany, the crucial question is if the transaction likely affects the public order and security. Correct – vague again. But this is surely an objective procedure with no political influence or bias affecting the outcome, right? Well, …

Foreign direct investment review can (very) roughly be compared to the steps as set out in the merger control proceeding:

- once you have a result of the filing requirements analysis,
- you need to prepare the filing,
- then submit this to the competent authority/ies,
- and wait for the clearance decision respectively reply to request for further information of the Ministry during the review period.

So, what's new and different compared to merger control? In Germany, foreign direct investment control might be applicable in case a non-German or non-EU investor acquires even less than 10% of the voting rights in the company. Further, the scope of the review is rather broad as there are no turnover thresholds or *de minimis* clauses. From a timing perspective, this review can be tricky. For example, in Germany, whereas merger control review takes one months, a mandatory foreign direct investment review will take at least two months.

WHAT START-UPS MIGHT BE SUBJECT TO THE GERMAN FOREIGN INVESTMENT CONTROL PROCEDURES?

Here is a flavor of what might be caught by the German investment control: critical infrastructure, software for such infrastructure, cloud computing services, medical products or medicines (introduced as a reaction to the COVID-19 pandemic), goods which use artificial intelligence, motor vehicles or unmanned aircraft, robots, IT products, goods for wireless or wired data networks. Early stages of product or software development may be sufficient to trigger filing obligations and delay the closing until a clearance is issued. Note: There is a lot more that can be covered. Ask our regulatory team!

16 Like merger control, there are numerous jurisdictions that already have a foreign direct investment control regime, *inter alia* Germany and the US.

6. THE LEGAL DOCUMENTS

In this part, we give a brief overview of the main legal documents that come up in the course of a German venture capital financing round. These include the term sheet, the investment agreement, the shareholders' agreement and the main ancillary documents.
It should be noted that unlike in the US market, where well-established market standards exist, such standards for venture capital financing transactions are only emerging in the German market, though we have seen much development in this sector over the last couple of years and these days, the documentation used by the leading VC law firms shows a lot of similarities.

> The term sheet is an important document, as it signals that the VC firm is serious about an investment and wants to proceed to finalize due diligence and prepare definitive legal investment documents. Before term sheets are issued, most VC firms will have gotten the approval of their investment committee. Term sheets are not a guarantee that a deal will be consummated, but in our experience a high percentage of term sheets that are finalized and signed result in completed financings.
>
> [*Richard D. Harroch*, Partner at Vantage Point Capital Partners (former partner at Orrick, Herrington & Sutcliffe)]

6.1 Term Sheet

A term sheet (also referred to as heads of terms, investment proposal, letter of intent or memorandum of understanding) is a document that outlines the key financial, legal and other terms of a proposed investment. At this point, after some discussion, the parties wish to confirm their preliminary mutual understanding on the key aspects of the financing round and their (future) rights and obligations as shareholders in the company. The term sheet usually also contains a number of conditions that need to be met before the investment can be completed, the conditions precedent. Typical conditions precedent are satisfactory due diligence, agreement on all legal documents, and, for institutional investors, approval by their investment committee or similar bodies.

Unlike the investment agreement and the shareholders' agreement, term sheets are not notarized. Furthermore, they are not legally binding, except for clauses such as "confidentiality", "governing law", "cost reimbursement" and "exclusivity/no-shop undertaking".

TERM SHEET STYLES – WHY ONLY HAVE TWO PAGES...

There is still often a remarkable difference between US-style and German market term sheets. Here, we are not so much talking about different deal terms (while there certainly are still some, we have seen quite a remarkable assimilation over the last years), no we are talking about the length of these documents.

US-style term sheets tend to be (significantly) shorter and are often more geared towards economic terms[17]. One of the main reasons is that in the US, the template investment documentation that has been published by the *National Venture Capital Association* and is regularly updated has gained widespread adoption so parties can assume that they will work on the basis of a relatively largely harmonized set of documents and can thus concentrate on what economically matters or where they want to deviate from the standard documentation.

Although we have seen a lot of development in this space, the level of standardization in Germany is still a far cry from what we have in the US. This might be one of the contributors to German market term sheets being usually much longer and often also dealing more with control matters as what a US investor would typically expect[18].

But the trend should be clear, term sheets will become shorter in Germany and will likely soon look a lot like the current West Coast standards. There is an increasing number of US VCs investing in Germany and investors have realized that a user-friendly term sheet is an important signaling device. By shortening the legalese and acknowledging widespread market standards, the investor can communicate a strong message: "We're founder friends and we're going to make this fast, easy and fair."

But why do term sheets even exist, wouldn't it speed up matters to get working on the long form documents right away after the founders and their prospective investor have agreed on a handshake deal? The answer seems obvious, but we still think it makes sense to pause for a minute and think about the main reasons for having a solid and reasonably detailed term sheet in place:

- Constraining Behavior and Alignment of Interests: In a perfect world, all people would be trustworthy and contracting parties would always behave in mutual agreement and interest. In this utopia, arguably no one would have a need for lawyers (the amount of cheers we usually get from literally any audience whenever we make this argument should give us reason to second-guess our professional choices, but we are usually too busy suing other people and trying to make our contracts just a little bit more complex). But in a business world in which self-interest is one of the dominant drivers of human behavior, term sheets can also create incentives for interest-based behavior in long-term contractual relationships and provide some legal teeth against bad behavior.
- Transaction Costs: Term sheets should set forth the main economic and control terms for the financing round and this should reduce the risk of misunderstandings. With a reasonably detailed term sheet, the parties will soon realize whether or not they really have a deal before those expensive lawyers are let loose and the costs will skyrocket (we understand the unifying effect a good lawyer bashing can have for all decision makers around the table, and yes, you are welcome).

17 A template published by the US National Venture Capital Association can be found here: https://nvca.org/recommends/nvca-2020-term-sheet-2/.

18 A template published by the German Standards Setting Institute can be found here: https://standardsinstitute.de/term-sheet/.

> [...] in a few places, this term sheet refers to certain terms as being "standard". That may seem vague and circular, but term sheets frequently do describe certain terms that way. What that really means is that there's an accepted practice of what appears in the docs for these terms among the lawyers who specialize in start-ups and venture deals, so make sure your lawyer (and the investor's lawyer) fit that description.
>
> [*Jason Kwon* and *Aaron Harris*, Y-Combinator]

- Reputation Constraints: While it is okay to negotiate term sheets and shop the terms one VC offers to solicit more attractive bids from other potential investors, once a term sheet is signed, founders and investors will be expected to honor the term sheet and use best efforts to implement the financing round based pursuant to what has been agreed in the term sheet. Walking away from a signed term sheet can hurt a party's reputation long term and far beyond the specific investment. The smaller the ecosystem, the more important a good reputation is. In this respect, the handling of conflict, ambiguities and disagreements will shape the reputation of entrepreneurs and investors both alike.

So parties should pay attention to what is set forth in the term sheet, which most often is presented by the investor rather than the company. However, the company and the founders can certainly benefit from having a master term sheet, at least for internal purposes, in order to benchmark offers that prospective investors put on the table.

6.2 Investment Agreement and Shareholders' Agreement

As part of the financing round, all existing shareholders, new investors and, typically, the company will enter into an investment agreement and a shareholders' agreement. Occasionally, these agreements are combined into one investment and shareholders' agreement (although for various technical and practicality reasons we are not a big fan of this approach and prefer having two separate agreements).

- Investments in a German start-up are usually implemented through a share capital increase. In the course of such increase, new shares are created, which the investors subscribe for against payment of their nominal value. In addition, the investors will undertake to pay additional funds, *i.e.*, the bulk of the investment funds, into the company's capital reserves. In the *investment agreement*, the parties set forth the terms and conditions for such capital increase, the details for the additional funding (amounts, milestones, etc.), guarantees given by the company (and, in many cases, by the founders and, to a lesser extent, by existing investors), and the remedies in case of a breach.
- In the *shareholders' agreement*, the parties set forth their rights and obligations as shareholders of the company, including corporate governance aspects (managing directors, optional advisory board, appointment rights, etc.) and certain veto rights for the investors, transfer restrictions, drag- and tag-along rights, provisions regarding liquidity transactions and the distribution of the resulting proceeds, and vesting provisions.

In most cases, both agreements will need to be notarized. It should be noted that the management board of the German start-up cannot implement a financing round by itself unless the shareholders have created an authorized capital (which is, however, usually only done to give the management the option to implement a second closing or the conversion of warrants granted to certain investors, *e.g.*, venture debt lenders). Rather, the decision about a financing round rests with the shareholders as the capital increase requires a shareholders' resolution adopted by at least 75% of the votes cast. For practical purposes, both the consent and active support of the financing round by all shareholders are required, or at least advisable, as the new investor will want to bring all shareholders under a single (new) investment agreement and shareholders' agreement. Thus, it will be important to establish clear voting requirements for all shareholders to support a future financing round, along with clear obligations to enter into the investment and shareholders' agreement if certain criteria are met (more on this to come in the following Chapters).

In the following Chapters we will present the most relevant and common provisions of the investment agreement and shareholders' agreement in more detail. However, for didactical reasons we have decided to present them not grouped by provisions that can usually be found in the investment agreement and the shareholders' agreement but rather by provisions that relate to *economics*, *i.e.*, who has what economic stake in the start-up and to control, *i.e.*, who can *control* the affairs and governance of the start-up and ultimately decide upon an exit. To provide our readers with a better overview, here is a synopsis on where the relevant provisions can usually be found.

Topic	Details can be found in the	Usually addressed in the term sheet?	Explained in more Detail in Chapter
ECONOMIC TERMS			
Pre- & post-money valuation	Investment agreement	Yes	A.III.1.
ESOPs, VSOPs and co.	Investment agreement (to the extent it relates to the pre-money valuation) and shareholders' agreement (as it relates to the implementation, amendment and economic burdens of the program)	Yes (but usually only the pool size and top-up of the existing pool are addressed in the term sheet)	A.III.2.
Investment amount and issuance of new shares	Investment agreement	Yes	A.II.2.
Forms of investment and mode of payment as well as default provisions	Investment agreement	Yes (only form of investment, *e.g.*, cash, media-for-equity etc.)	A.II.4.
Secondary share sales	Investment agreement (sometimes separate agreement)	Yes	A.III.4.
Representations, warranties and remedies in case of breach	Investment agreement	Usually not in detail	A.III.5.
Antidilution	Shareholders' agreement	Yes	A.III.6.1
Preference dividends	Shareholders' agreement	Yes (if any)	A.III.6.2
Liquidation preferences	Shareholders' agreement	Yes	A.III.6.3
CONTROL TERMS			
The advisory board	Shareholders' agreement	Yes (appointment rights for incoming investors)	A.IV.1.1
Investor majority and investor veto rights	Shareholders' agreement	Yes	A.IV.1.2
Information and monitoring rights	Shareholders' agreement	No	A.IV.2.
Management rights letters for US investors – ERISA compliance	Shareholders' agreement	Usually not	A.IV.2.2
ESG	Shareholders' agreement	Sometimes	A.IV.3.1
IP provisions	Shareholders' agreement	No	A.IV.3.2
Pooling	Shareholders' agreement	No	A.IV.3.3
US tax covenants	Shareholders' agreement	No	A.IV.3.4
Rules on share transfers and founders' lock-up	Shareholders' agreement	Yes (at least general description)	A.IV.4.1
RoFO and RoFR	Shareholders' agreement	Occasionally	A.IV.4.2
Drag-along and tag-along	Shareholders' agreement	Yes(at least required majority for a drag-along right)	A.IV.4.3
IPO-related provisions	Shareholders' agreement	Occasionally (in later rounds with incoming US investors)	A.IV.4.4
Founder vesting and leaver events	Shareholders' agreement	Yes	A.IV.4.5

DIFFERENCES FROM US AND UK INVESTMENTS: THE FINANCING ROUND AGREEMENTS

US financing rounds usually include the following agreements:

- The new investors and the company will enter into a stock purchase agreement under which the new investors will typically purchase preferred stock. This stock purchase agreement will contain certain representations and warranties given by the company, including the validity of the preferred stock being purchased and, in most cases, certain operational and financial representations and warranties.
- The company's charter (also referred to as certificate of incorporation), together with its bylaws, will set out certain rights of the shareholders, including liquidation preferences, antidilution protection and veto rights (for details, see below).
- In an investors' rights agreement, the investors are granted certain rights, which typically include information rights, preemptive rights in case of future issuance of new securities and registration rights pursuant to which the investor can request the company to publicly register the company's common stock (and sometimes preferred stock) with the SEC in connection with or following an initial public offering of the company.
- In a separate voting agreement, the parties stipulate how the stockholders will appoint and remove directors on the company's board. These agreements may also contain provisions regarding the shareholders' obligations to vote in favor of exit transactions (known as a drag-along), provided that certain criteria are fulfilled (*e.g.*, approval of the transaction by the board, a majority of common stock and a majority of preferred stock).
- Finally, the parties may enter into a separate right of first refusal and/or co-sale rights agreement, which states that if holders of common stock propose to sell their shares to a third-party buyer, the holders of preferred stock have a right of first refusal to match the third-party offer or, alternatively, the holders of preferred stock can participate in the sale (co-sale) by selling their preferred stock on a *pro rata* basis. Typically in US financing rounds, the right of first refusal obligation is imposed on only the founders or key employees' shares as opposed to German financing rounds where the right of first refusal obligation is imposed on all shareholders.

UK financing rounds usually include the following agreements:

- The new investors and the company will enter into a share subscription agreement under which the new investors will typically subscribe for preferred stock. This subscription agreement will contain certain warranties given by the company and founders, including the validity of the preferred stock being subscribed for and, in most cases, certain operational and financial warranties.
- The company's articles of association will set most share and other rights of the shareholders, including liquidation preferences, drag-along, tag-along and antidilution protection. By having all operative provisions contained in the articles of association, such terms apply to all shareholders by operation of law.
- The shareholders' agreement, which principally covers board appointment rights, information rights, restrictive covenants of the founders and veto rights.

Please note that the above list is just a high-level summary and that these agreements can vary across transactions and sometimes are combined.

6.3 Ancillary Documents

The investment agreement and shareholders' agreement often contain a number of ancillary documents that further specify the rules of engagement for the investor and the existing shareholders. Among them are the following documents:

Articles of Association

In most financing rounds the articles of association of the company will need to be amended to reflect the increased share capital of the company and the new class of shares that will be issued to the incoming investor. In addition, the investor may request other changes to the existing articles of association. Specifically, some of the protective provisions contained in the shareholders' agreement may be reflected in the company's articles of association as well. Protective provisions that are sometimes found in the articles of association include preference dividends, liquidation preferences and investor majority rules. As we will see in Chapter A.II.3., today, articles of associations of VC-backed start-ups will also usually contain detailed provisions regarding the establishment, composition and role/powers of an advisory board.

Including certain protective covenants in the articles of association can provide a higher level of protection, as provisions in the articles of association have an in rem effect (*dingliche Wirkung*), while provisions in the shareholders' agreement are only contractual arrangements that apply among the parties to those agreements. One drawback to having those protective covenants in the articles of association is that for a GmbH or UG (*haftungsbeschränkt*), the articles of association must be filed with the commercial register and are publicly available, while the investment agreement and shareholders' agreement can be kept confidential. Further, to maintain such confidentiality in the investment agreement and shareholders' agreement, the articles of association must not contain any explicit references to an existing investment agreement or shareholders' agreement. Otherwise, this may result in the commercial register also requesting the filing of such agreements.

Rules of Procedure for the Advisory Board and the Management Board

Start-up companies must have a management board to run the daily operations and to represent the company toward internal and external constituencies, and many start-ups in Germany have established an advisory board to advise and supervise the management board (for more on the corporate governance of VC-backed German start-ups, see Chapter A.IV.1.). For both corporate bodies, the financing documentation usually contains rules of procedure (*Geschäftsordnung*).

Rules of procedure for the management board specify the responsibilities of the managing directors of the company. They will also specify the actions and matters for which the managing directors require prior approval, either by the shareholders and/or the advisory board of the company.

Rules of procedure for the advisory board usually also contain provisions regarding the convocation of advisory board meetings and how advisory board resolutions shall be adopted.

III. Economic Terms

Finally, we can leave the legal mambo jambo behind and talk numbers and economic stuff. No one ever asks how sentences like "let's agree on the valuation and key economics and then let the lawyers figure out the rest" makes us feel, but that is a different story.

In this Chapter we discuss key terms that make up the economics of a VC deal, including valuation, employee participation program (and its impact on valuation), financing round implementation and some way how VCs seek to minimize the "venture" aspect of their business by economically protecting their investment. While clearly also having significant economic relevance, we will discuss founder vesting and leaver provisions in the context of the other share transfer provisions (see Chapter A.IV.5.).

1. PRE- & POST-MONEY VALUATION – AND IT IS "FULLY-DILUTED"

Let's start by defining a couple of the most relevant economic terms that can be found in all investment agreements and term sheets: "pre-money valuation", "post-money valuation" and "fully-diluted".

The pre-money valuation of a company is the valuation of the company that the existing shareholders and the new investor agree upon prior to the new financing round, *i.e.*, before the new investor puts any money into the company. The pre-money valuation is used to determine how many shares the new investor will get for its investment. Economically speaking, the pre-money valuation divided by the fully-diluted number of shares of the company determines the price per new share that the investor will have to pay. Please note that this price will be the benchmark for the antidilution protection of the investor in case of a future down round (for details, see Chapter A.III.6.1) as well as the benchmark for the investor's liquidation preference (for details, see Chapter A.III.6.3). The pre-money valuation is to be distinguished from the post-money valuation, which refers to the valuation of the company immediately following the new financing round.

For example, if the company has a share capital of EUR 25,000 divided into 25,000 shares with a nominal value of EUR 1.00 each (let's assume for simplicity's sake that there are no virtual shares or convertible securities, *i.e.*, in this case the fully-diluted number of shares is equal to the actual number of the existing shares), and founders and investors have agreed on a pre-money valuation of the company of EUR 9,000,000, then the price per share with a nominal value of EUR 1.00 is EUR 360 (EUR 9,000,000/25,000 = EUR 360). If the investor agrees to invest EUR 1,000,000, this will "buy" the investor EUR 1,000,000/EUR 360 = 2,778 (rounded) shares in the company, *i.e.*, 10% of the share capital of EUR 27,778 post-financing. The post-money valuation of the company is EUR 9,000,000 + EUR 1,000,000 = EUR 10,000,000.

VALUATION METHODS FOR START-UPS

The valuation of early-stage and growth technology companies requires the use of alternative valuation approaches. The lack of reliable historical financial data and the high level of uncertainty render traditional valuation methods, in many cases, more or less useless. Start-up valuation requires a greater understanding of the qualitative aspects of the company, such as the underlying technology, the size of the relevant market, and also softer factors, including the quality and experience of the team. On top of that are factors that may seem unrelated to the company but actually have an impact. These would include the location of the start-up, as in competitive markets like Silicon Valley, valuations may soar quickly.

We, as lawyers, are not the right people to give a comprehensive lecture on what drives start-up valuations.[19] And as long as the valuation is a negotiated outcome like the pre-money valuation of a financing round, there is no need for us to get involved. However, there can be situations when it becomes necessary to determine the valuation of a company, or the valuation of one shareholder's stake, yet the involved parties may not agree on a valuation. In particular, we see this in cases such as an involuntary redemption of shares, or when call-options are exercised in case of a founder leaver event. Here, simply stating in the investment documentation that the price for the shares shall be their "fair market" value (or a fraction thereof) is not very helpful. When a third-party expert is then asked to value an early-stage company, things can become tricky very quickly if that third-party expert is not given some guidance on how the fair market valuation shall be determined. We like how *Aswath Damodaran* summarized the problem in his book 'The Dark Side of Valuation': "There can be no denying the facts that young companies pose the most difficult estimation challenges in valuation. A combination of factors – short and not very informative histories, operating losses and the [...] high probability of failure – all feed into valuation practices that try to avoid dealing with the uncertainty by using a combination of forward multiples and arbitrarily high discount rates."

In practice, we see sometimes references to the IDW Standard No. 1 Principles for the Performance of Business Valuations (*IDW S 1 – Grundsätze zur Durchführung von Unternehmensbewertungen*), as amended from time to time or, especially in a more international context, the 'International Private Equity and Venture Capital Valuation Guidelines' as promoted by the IPEV Board. In some cases, it might be an easier and more practicable way to have a clause in the documentation that declares the post-money valuation of the last financing round to be binding for the fair market value of the company if that round has occurred within a reasonable period of time (*e.g.*, between six and twelve months) and potentially applying a certain discount to reflect the lack of liquidity and control rights of the called shares. In order to avoid unfair outcomes, the shareholders' agreement can provide for a tail period clause pursuant to which if a new financing round with a higher pre-money valuation occurs within a short period of time following the departure of the respective shareholder (*e.g.*, three months), then the valuation of this later financing round shall be the point of departure for the determination of the fair market value of the company and any compensation already paid to the departing shareholder would be retroactively adjusted.

19 One of the authors of this Guide (Sven) still believes that it also has something to do with last weekend's football results, which would make him, as a diehard supporter of Hamburger SV, probably a pretty grumpy and pessimistic investor.

DIFFERENCES FROM US AND UK INVESTMENTS: PURCHASING NEW SHARES VS. SUBSCRIPTION FOR NEW SHARES

You might have noted that in the preceding section when saying that the pre-money valuation of a company is determined to calculate the price per share that the investor has to pay in order to "buy" a new share, we put the word "buy" in quotation marks. The reason for this is that while it is economically correct to talk about the purchase price of a new share, unlike in the US and the UK, in German deals the investors don't enter into a purchase agreement with the company when acquiring new shares and do not pay a purchase price per share to the company. Rather, equity investments in a German start-up are usually implemented through a share capital increase (*Kapitalerhöhung*). In the course of such increase, new shares are created, which the investor subscribes for against payment of their nominal value in cash (*Barkapitalerhöhung*). In addition, the investor will undertake to pay additional funds, *i.e.*, the bulk of the investment funds, into the company's capital reserves within the meaning of sec. 272 para. 2 no. 4 German Commercial Code (*Handelsgesetzbuch*).

Fully-diluted is a concept that is theoretically rather easy to grasp but has significant implications on what percentage of the company an individual will hold after financing rounds. In a nutshell, fully-diluted describes how the denominator will be calculated when determining the price per share. In our example above, this number was 25,000 because we assumed that there are only "real" shares that have already been issued.

Fully-diluted does, however, usually not only include the shares that have been issued by the company, but also

- shares allocated to the employee option pool (be it an equity-based or virtual share pool); and
- any other shares that the company could be required to issue through options, warrants, convertible debt or other commitments.

Whether the shares and virtual shares under an equity-based or virtual employee stock option plan are included in the definition is a matter of negotiation. The investor will want to make sure that the company has sufficient shares/options reserved for its managers, employees and sometimes consultants. Keep in mind that though German start-ups tend to use virtual stock option plans instead of equity-based employee stock option plans (for details, please see Chapter A.III.2.), the economics stay the same.

For illustration purposes, please find below a table providing a simplified overview on how a *pro-forma* table can look like.

Example:

- The investor offers an investment of EUR 2m on a fully diluted pre-money valuation of EUR 18m.
- The company has created a VSOP pool of 5,000 virtual shares (each economically equivalent to one share of common stock with a nominal value of EUR 1.00) of which 3,000 are unallocated.
- The company has raised EUR 500k in convertibles that will now convert with a 20% discount (but has no cap).

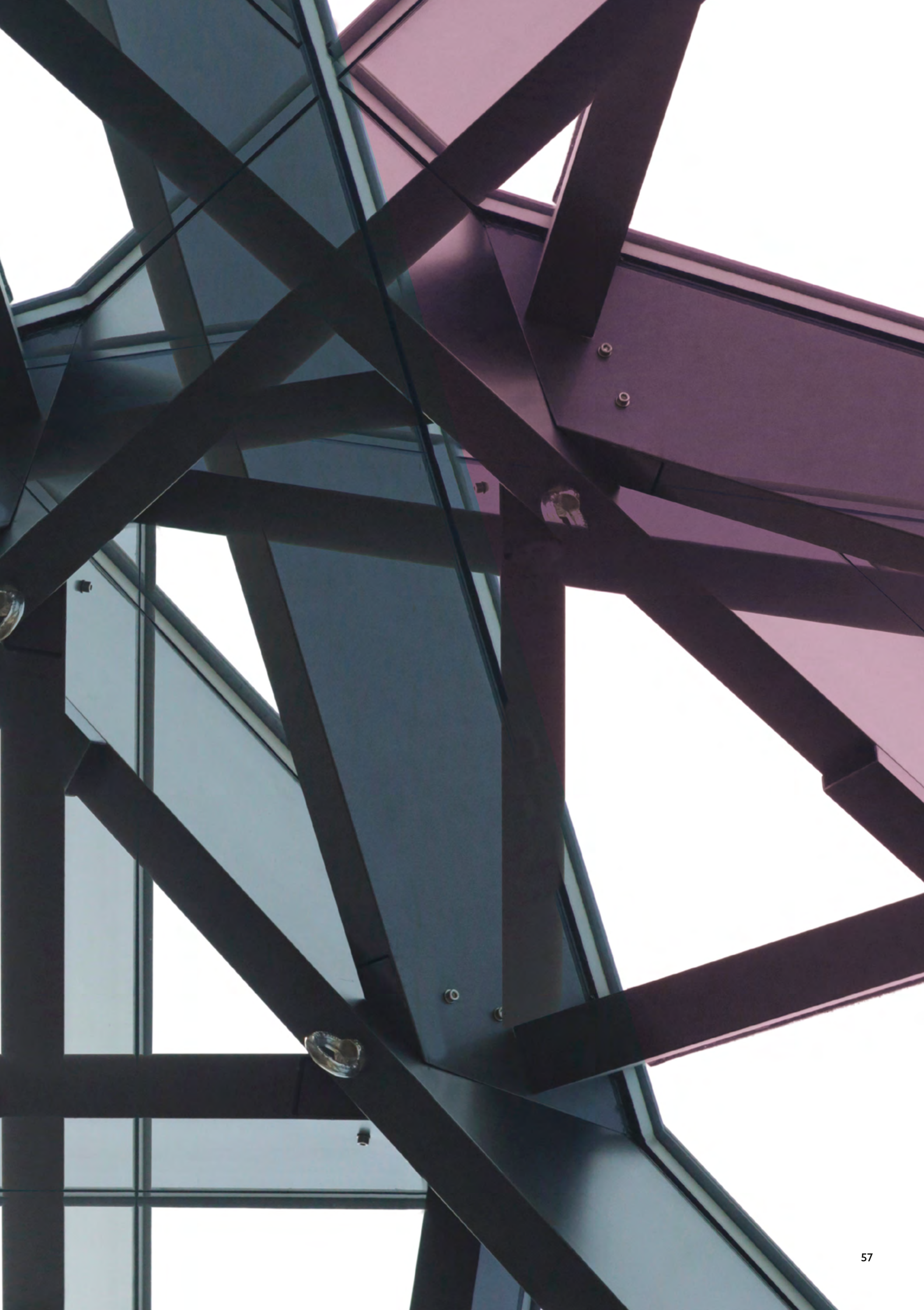
	Pre Financing Round			Post Financing Round		
	Number of Shares (nominal value EUR 1.00 each)	**% not fully diluted**	**% fully diluted**	**Number of Shares (nominal value EUR 1.00 each)**	**% not fully diluted**	**% fully diluted**
Founder 1	12,500	37.76%	32.81%	12,500	32.21%	28.54%
Founder 2	7,500	22.66%	19.69%	7,500	19.33%	17.12%
Founder 3	7,500	22.66%	19.69%	7,500	19.33%	17.12%
Angel 1	3,500	10.57%	9.19%	3,500	9.02%	7.99%
Angel 2	2,100	6.34%	5.51%	2,100	5.41%	4.79%
Investor	**–**			**4,380**	**11.29%**	**10.00%**
Holders of Convertible Loan (CLA)	–			1,323	3.41%	3.02%
Share Capital	**33,100**	**100.00%**		**38,803**	**100.00%**	
ESOP	5,000		13.12%	5,000		11.41%
thereof unallocated	*3,000*			*3,000*		
Share Capital + ESOP	**38,100**		**100.00%**	**43,803**		**100.00%**

Pre-Money Valuation	18,000,000.00 €
Basis for Conversion of CLA*	472.44 €
Fully Diluted Share Price**	456.57 €
Investment Amount	2,000,000.00 €
CLA Amount	500,000.00 €

* taking into account Share Capital and existing ESOP but before discount

** taking into account Share Capital, existing ESOP and CLA

When determining the pre-money valuation in a down round, the incoming investor will need to check if the company's existing investors have down round protection. If so, the new investor must include any antidilution shares to be issued to the existing investors (for details about how antidilution protections are implemented in Germany, see Chapter A.III.1.) in its pre-money fully-diluted cap table. As the antidilution shares would effectively dilute the new investor, the new investor will adjust the pre-money valuation, which, in turn, will again affect the antidilution formula and the number of new antidilution shares to be issued to the existing investors. This will influence the new investor's pricing of the financing round. This sounds more complex than it actually is; with standard algebra and the iteration functions of today's spreadsheets, it is possible even for lawyers to price any down round financing in this manner. Similar questions occur when there are convertible loans outstanding.



2. ESOPS, VSOPS AND CO.

On their growth trajectory, start-ups require financing, as well as qualified staff, to support their growth. However, employees often cannot be offered enough cash compensation. Employee participation programs play an important role in attracting and binding qualified personnel. Compensation in the form of employees' participation in start-ups can be an interesting option for founders as well as investors. A specifically structured employee stock option plan can help align key employees' incentives toward a successful exit.

> Start-up equity is a complex financial derivative that powers the entire venture-start-up-ecosystem. It's not profit sharing, it's not an union but it is the greatest tool of employee empowerment I have ever seen.
>
> [*Eric Ries*, The Start-up Way]

2.1 Terminology

Talking about employee ownership programs can be confusing at times (not to mention getting the numbers right...). There is a lot of financial jargon and VC lingo that can make ploughing through the mechanics as well as commercial and tax issues of a program even harder. In the German market, things are further complicated by the fact that, as is so often the case in VC land, we try to replicate and emulate what has been developed in the USA – where employee ownership in start-ups is a standard feature and well established documentation and commercial benchmarks exist. In Germany, our corporate and tax laws don't allow for a simple adoption. Keep in mind that in Germany for reasons we have explored elsewhere[20] start-ups use both virtual and equity-based programs that are in practice often simply referred to as "employee stock option programs" or "ESOPs", although they have a different structure and logic.

While in this Guide, we cannot go into all the nuts and bolts of employee ownership programs, we want to at least present the essentials given the importance of employee ownership for a start-up's success. So, let's make our life a bit easier and agree on some basic terminology we will use throughout this Guide:

- ESOP: We will use this term for equity-based programs, *i.e.*, programs that grant employees options for "real" shares. When discussing equity-based programs we will also discuss direct participations, *i.e.*, giving beneficiaries "real" shares instead of only options.
- VSOP: We will use this term for virtual programs, *i.e.*, programs that economically seek to simulate an ESOP without issuing real shares or options for real shares.
- Employee Ownership: We will use this term as an umbrella for the various forms of allowing employees participate in the equity upside of their employer start-up, usually in the form of an ESOP or VSOP.
- Stock Options: For ease of reference we will apply this term to all kinds of options or (virtual) shares issued under an ESOP or VSOP. But keep in mind that, for example, in case of a VSOP, a virtual (stock) option does not actually give its holder a right to acquire real shares.

But beware: In the international context, the terms used in Germany tend to cause confusion. For example, what is commonly regarded as an "ESOP" in Germany may be qualified as a "restricted stock unit program" in the USA. In the international context, and especially when issuing Stock Options under an ESOP to international beneficiaries, particular attention must be paid to this matter, as misunderstandings can easily arise. Experience has shown that these misunderstandings often only become apparent at a later date in the future when tax obligations have to be met.

20 For more details on employee ownership programs and how best to structure and implement them see our Guide *OLNS#8 – ESOPs, VSOPs & Co.*, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/2021/olns-8-esops-vsops-co.pdf.

2.2 Importance for the Financing Round

Employee Ownership programs play an important role in VC financing rounds as the size of the existing pool and any agreements about pool increases will be important factors for the start-up's fully-diluted pre-money valuation and thereby the dilution that the existing shareholders will suffer as a consequence of the financing round.

In a financing round, how many preferred shares the investors will get depends on the agreed fully-diluted pre-money valuation of the company. The pre-money valuation is divided by the fully-diluted number of shares in the company to determine the price per share of preferred stock that the investor will have to pay. The total number of issued shares as well as the securities convertible into shares and virtual or real Stock Options under Employee Ownership programs is collectively usually referred to as a start-up's fully-diluted cap table and this number is used to calculate the aforementioned price per new preferred share.

This is why when negotiating a financing round or comparing competing term sheets founders need to have a look at what the incoming investor requests about the pool of available unallocated Stock Options post financing. The reason is that it is common for investors to request a top-up/increase of the Stock Option pool prior to their investment. This increased number of Stock Options will then increase the number of fully-diluted shares to be considered and reduce the price per preferred share. This means that such increase would only dilute the existing shareholders but not the new investors. So when only looking at the pre-money valuation offered by a potential investor, a higher request for an increase of the Stock Option pool may ultimately make an offer less attractive for the existing shareholders. Thus, the post-closing pool can be a critical negotiating point and could be the link to obtaining a higher price per share if the parties agree on a smaller pool increase or – often more appropriate when the company actually needs more Stock Options for its hiring plans – that while the pool shall be increased, only a portion of such higher number of Stock Options shall be taken into account when calculating the number of fully-diluted shares. The latter means in economic terms that for the portion of the pool increase that is not reflected in the fully-diluted share number the new investors will share in the resulting dilution.

Let us repeat this. Your start-up will only succeed if you hire people that are as dedicated as you are and ideally a bit smarter (at least in some areas). Here, your ESOP is mission critical. But an ESOP that is not understood by the beneficiaries or not perceived as valuable will do nothing good while still diluting your stake in the start-up. Explain it, explain it more and then repeat.

The table below provides an illustration of how Employee Ownership top-ups as part of a financing round can dilute the existing shareholder (we took this example from the very insightful and highly recommended publication Rewarding Talent from Index Ventures).

	Pre Series A	Post A – 10% ESOP	Post A – 15% ESOP	Post A – 20% ESOP
Founders	65%	47%	43%	40%
Existing Investors	25%	18%	17%	15%
New Investors	0%	25%	25%	25%
ESOP – existing	10%	7%	7%	6%
ESOP – top up	–	3%	8%	14%
ESOP – Total	**10%**	**10%**	**15%**	**20%**
Total Ownership	100%	100%	100%	100%

Source: *Rewarding Talent* - A Guide to Stock Options for European entrepreneurs, *Index Ventures*

Founders should carefully consider the size of the option pool and whether it is taken into account in the valuation of the company. If it is a large pool and it is included, it can significantly lower the pre-money valuation. To illustrate this point, let's look at a simple example. An investor has agreed to invest EUR 2,000,000 on a basis of a pre-money valuation of EUR 8,000,000. This would give the investor a 20% stake. The investment and shareholders' agreement stipulates that the company shall have a new employee stock option plan with a volume of 10% of the company's share capital after consummation of the financing round. If this pool will be included in the definition of "fully-diluted", *i.e.*, the economic burden of the new program shall be borne by the existing shareholders, this would effectively reduce the pre-money valuation by EUR 1,000,000.

2.3 Key Terms and Market Standards

This is for those of you who only read articles that can be finished over one cup of espresso (granted, it will take you more than one espresso for this but think about your local barista). Here is a high-level summary of certain key terms of Employee Ownership programs that many German start-ups have implemented as well as some considerations on what we would consider market standard[21].

Key Terms and Questions	Market Standards
STOCK OPTIONS AND BENEFICIARIES	
What is the size of the pool of Stock Options and what will be the nominal amount per Stock Option?	Various VCs recommend that the Employee Ownership pool (excluding for the avoidance of doubt any Stock Options granted to founders) should grow alongside the financing rounds and approximately match the following benchmarks for total pool size: • Seed – Series A: 7.5-10% • Series B: 9-12% • Series C: 12-15%+ Under a VSOP, the beneficiary receives upon an exit or liquidity event (only) a payment that is derived from the amount that a shareholder gets for a common share in the start-up (usually 1x or in case of lower denominations a fraction thereof per Stock Option, *e.g.*, 0.001x) minus the strike price set for the respective Stock Option. But it is often also true in case of an ESOP as options are often also settled in cash here, *i.e.*, the beneficiary receives a payment in an amount equal to the sale price for the number of shares the beneficiary would have received for the options minus the relevant strike price.
Who shall be an eligible beneficiary for Stock Options? Only employees of the company and its affiliates or also outside advisors and consultants?	Many programs do not have restrictions in this respect. One thing that start-ups should keep in mind is that whenever they are allocating Stock Options to a beneficiary who is not subject to German taxation it is advisable to check with qualified counsel. In particular typical German market VSOPs require adjustments when used with beneficiaries in the US to avoid potentially serious tax issues.
Under which circumstances shall the company be entitled to amend or to substitute the Employee Ownership program by another participation program?	It is advisable to build some flexibility into the program to allow for example a substitution in case of a flip into a US holding structure or the replacement of a VSOP by an ESOP in case of a conversion of the start-up into a stock corporation.
ALLOCATION	
Who decides about the allocation of Stock Options to the beneficiaries and the terms of the allocation?	While the shareholders' meeting and/or advisory board is usually competent to approve the program in its entirety as well as major amendments, allocation decisions (potentially within pre-approved parameters) are usually made by the management board (with the approval of the advisory board in certain circumstances, *e.g.*, particularly large grants), and by the advisory board with regard to any allocation of Stock Options to members of the management board.

21 All these questions and much more is addressed in our Guide *OLNS#8 – ESOPs, VSOPs & Co.*, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/2021/olns-8-esops-vsops-co.pdf.

Key Terms and Questions	Market Standards
How are Stock Options allocated?	The Stock Options are usually allocated to the respective beneficiary by executing an offer letter addressed to the beneficiary indicating the granting of a determined number of Stock Options. Other terms that can be set forth in an allocation letter include the applicable number of allocated Stock Options and/or the commencement date for the vesting period and the terms of the vesting, as well as a "base" or "strike" price for each Stock Option to be taken into account when determining the payment amount to which the Stock Options shall be entitled in case of an exit.
What about Top-Ups?	As the amount of vested Stock Options increases over time, those that remain unvested become less meaningful in incentivizing the employee to stay with the start-up. Thus, the company should consider so-called refresher or top-up grants (sometimes also referred to as evergreen grants). These are additional options awarded on a more or less regular basis beginning 3-5 years after an employee's initial grant. Generally, we see more variability in refreshers' sizes and vesting structures in our practice. For example, the refresher can come in the form of another single, large grant, or repeating grants of 25-50% the size of a grant the employee would receive if hired today (depending on length of vesting and grant cadence). As an alternative, a refresher could already be granted in year 4 of the initial grant again with a four year vesting schedule of which the first 10% would vest in year 1, *i.e.*, in parallel to the 25% vesting of the initial grant in the same year with subsequent 30% vesting increments over the next three years.
VESTING AND FORFEITURE IN CASE OF LEAVER EVENTS	
Vesting, Vesting Period and Cliffs	Put simply, vesting means that Stock Options must be earned by the beneficiary over time. The vesting schedule is the timetable over which a beneficiary accrues the right to keep the Stock Options that have been awarded (the respective period is the vesting period). Vesting is a standard feature of Employee Ownership programs and protects the start-up. It stages the economic accrual of Stock Options, mitigating the risk that an employee will depart with an undeserved (virtual) stake in the company. It emphasizes the retention element described above as it continually incentivizes employees as they earn their Stock Options package over the course of the vesting period. In line with this purpose, Employee Ownership programs also usually foresee what is called a cliff, meaning that the individual must be with the company for the period of the cliff to vest the first increment of her Stock Options. • Vesting period is usually set at 48 months, occasionally 36 months (but in the latter case, the Stock Option packages are usually somewhat smaller). • Vesting occurs usually linear on a monthly basis, sometimes on a quarterly basis. • These days, the cliff period is almost always set at 12 months. So in case of the standard vesting period of 48 months with linear vesting, a 12 months' cliff means the beneficiary will get 0% vesting for the first 12 months, 25% vesting after the 12th month, and 1/48th (2.08%) more vesting each following month until the 48th month. In certain circumstances, it might make sense to emphasize the retention element of Employee Ownership programs, *i.e.*, provide more economic incentives for the beneficiary to not leave during the vesting period by for example: • Longer cliff periods of sometimes 24 months; or • Back-loaded vesting schemes that allow the beneficiaries to accumulate the larger portion of their options only in the second half of the vesting period. For example, instead of giving a beneficiary 25% vested Stock Options after each of the four years making up the vesting period, a back-loaded scheme could for example foresee 10% of the Stock Options to vest after year one, another 20% after year two while the bulk of the Stock Options would only vest in years three (30%) and four (40%).

Key Terms and Questions	Market Standards
Will there be an accelerated vesting in case of an exit?	Minefield, investors and a potential acquirer of a start-up will usually not like provisions that will accelerate the unvested portion of the Stock Options just because an exit event occurs during the vesting period (so-called single trigger acceleration). Standard these days are the so-called double-trigger acceleration provisions that will make an acceleration subject to the second trigger that the beneficiary is terminated by the start-up within a certain period after the closing.
Good, Bad and Grey Leavers	Many Employee Ownership programs distinguish between good and bad leavers. The consequence is often that good leavers can keep their vested Stock Options while bad leavers lose them. In most cases, bad leavers lose all their vested Stock Options; occasionally we come across plans where bad leavers "only" lose a portion of their vested Stock Option or only get a significantly reduced payment for their vested Stock Options upon exit but can otherwise keep them. In Germany and more broadly in many European start-up hubs the sentiment to leavers is often decidedly different than in the United States, where the good leaver is the norm and there are usually significantly narrower definitions of what constitutes a bad leaver. Case in point: An often debated question in German start-ups is whether employees who simply choose to leave or are terminated for poor performance (which in itself does not constitute "good cause" for a termination under German law) should qualify as bad leavers. In the United States, both cases would hardly ever qualify as bad leavers. In Germany, the situation can be different. Here, some plans qualify such beneficiaries as bad leaver (at least if the voluntary departure occurs during the vesting period) or subject them to what is called a "negative vesting." In recent years, quite a number of investors have argued to adopt the more lenient US approach also for German plans and advise not to foresee bad leaver provisions at all or at least exclude the aforesaid cases of a voluntary leaver or underachievement and limit bad leaver provisions to "really bad behavior," *e.g.*, fraud, criminal misconduct or certain cases of unethical behavior.
EXIT PAYMENTS	
What constitutes a relevant "exit" (see also under Chapter A.IV.4.)?	There are usually three events that constitute a relevant "exit," *i.e.*: • Divestment of more than 50% of the nominal capital of the start-up (share deal exit); • Divestment of more than 50% of the start-up's assets (asset deal exit); and • IPO of the start-up, here some plans might include or exclude a direct listing and most recently some plans also qualify certain de-SPAC transactions as an IPO.
How will the amount of an exit payment per Stock Option be calculated?	In a typical VSOP, the program will provide that the Stock Options will entitle the beneficiary to a gross amount equal to the exit proceeds remaining after deduction of all transaction costs that a holder of a common share would be entitled to after deduction of all liquidation preferences and the costs of the VSOP (or a fraction thereof if one Stock Option does not correspond to a common share with a nominal value of EUR 1.00 but a smaller denomination.) If there is a base or strike price per Stock Option, the amount of the base or strike price would be deducted from the amount the beneficiary is entitled to. Often, any form of deferred payments that the shareholders might get in an exit (*e.g.*, earn-out payments) are excluded from this calculation. In case of an IPO exit, the relevant benchmark price will be derived from either the IPO price or a weighted average price over a certain number of trading days.
What are the terms of payment?	For example, will the entire amount of exit proceeds be paid out right away or over a certain period of time and subject to the beneficiary not terminating her employment or service agreement with the company (such a deferred payment mechanism might be relevant for the acquirer of the company to ensure the going concern of the company following its acquisition).

3. FINANCIAL CONTRIBUTION BY THE INVESTOR

3.1 Forms of Financial Contributions and Milestones

Forms of Financial Contributions

In the investment agreement, the new investor(s) and those existing shareholders, if any, who participate in the financing round undertake to subscribe for the new shares, pay the nominal amount of the new shares (*i.e.*, their par value) to the company in cash and make further financial contributions. Such other financial contributions can come in various forms. Most often the investor undertakes to pay a cash amount into the capital reserves of the company (if you have a background in US venture capital deals, then think about the sum of both, the nominal capital payment and this additional capital contribution as the "purchase price" that the investor pays under a US securities purchase agreement).
The investor may also contribute an existing convertible loan into the company or occasionally undertake to provide certain services (best known examples for the latter category are the media-for-equity transactions).

- If the investor is obligated to contribute **cash** into the company, usually the bulk of its investment funds is made as a nonstatutory payment into the Company's free capital reserves pursuant to sec. 272 para. 2 no. 4 German Commercial Code (*Handelsgesetzbuch*). This amount will be equal to the total investment amount minus the nominal amount of the new shares that is made as cash contribution in the course of the capital increase (*Barkapitalerhöhung*). Sometimes, these payment obligations are made in tranches and these tranches can be subject to the achievement of certain milestones (please see below).
- If the investor has extended a **convertible loan** to the company prior to the financing round and is now converting its loan receivables into equity, this is usually implemented by a small cash capital increase plus a contribution of the loan into the free capital reserves of the company. The investor will make a small cash payment in the nominal amount of the investor's new shares and will agree to contribute and assign to the company the loan receivable, including claims for accrued but unpaid interest into the company's free capital reserves. When the assignment becomes effective, the company's obligation to repay the loan and the accrued interest will cease to exist (*Erlöschen durch Konfusion*).
- **Media-for-equity investments** by media/publishing outlets (corporate media) or media equity funds are designed to provide the company with media reach and increase its metrics in a very short period of time while the investor can leverage its unsold advertisement inventory. In exchange for the equity investment, the company receives (in addition to the small cash amount for the nominal value of the new shares) advertising space at discounted rates; details are usually set forth in a so-called media service agreement (*Medialeistungsvertrag*) including, for example, broadcasting slots, rights to postpone publications, and gross rating points. Media-for-equity transactions can raise, among others, tax and accounting questions that should be reviewed in detail on a case-by-case basis. Although the importance of such financings has declined significantly over the last couple of years, these structures are still around sometimes yield remarkable successes. The now publicly listed Auto1 Group, *i.e.*, attributes a significant part of its success to its long-standing partnership with SevenVentures, German Media Pool and Fashion Media Pool, which held shares worth EUR 148 million post the company's IPO. SevenVentures, the VC-branch of ProSiebenSat.1 Media SE, also attracted attention in May 2021 with a media investment in the Sanity Group, planning to promote CBD-brands such as VAAY and This Place.

To protect the investor, the investment agreement should contain a provision clarifying that the obligation of the investor to make further financial contributions to the company shall exist only among the investor and the existing shareholders, but it is not explicitly assumed vis-à-vis the company, and that the company shall not have any claim for payment in its own right (also not pursuant to sec. 328 German Civil Code (*Bürgerliches Gesetzbuch*)). The reason for this is that in case of an unexpected insolvency of the company prior to closing, its insolvency administrator could otherwise still request fulfilment of the respective contributions.

Milestones

Sometimes (though we see this usually only in earlier stage companies) the investor will not want to make its entire investment in one tranche upon closing of the financing round but, rather, will want to invest in tranches, subject to the achievement of certain milestones. Milestones are usually technical and/or commercial targets (*e.g.*, completion of a prototype or minimal viable product according to certain specifications, proof of concept or market or certain revenue or customer acquisition goals) that the company has to meet. If the milestones are met, then the investor is obliged to pay in the further tranche(s). If not, it is usually up to the investor to decide whether or not to waive the fulfillment of the milestones and make the investment irrespective of the company's failure to achieve the milestone(s).

The advantage of a milestone-staged financing for an investor is pretty straightforward. The investor can limit its risk, as subsequent tranches will only need to be paid out once certain expectations regarding the future development of the company or its offerings are met. There are benefits to the company as well, as the company gets more manageable infusions of capital over time, which eliminates the risk that the company could waste its funds by having too much money at the start and not enough direction as to where the funds should be allocated. On the flip side, milestones can also set the company on the wrong path when the founders are too focused on achieving a (sometimes arbitrary or no longer relevant) goal while missing out on greater opportunities or not confronting mounting challenges head on.

If founders and investors opt for a milestone-based financing, they should agree on realistic milestones and have the milestones set forth in the investment agreement as clearly as possible. A good litmus test is to be able to answer this question in the affirmative: "Has the milestone been defined in a way that an outsider could decide herself whether or not the milestone has been achieved without knowing anything about the negotiation history between founders and investor?" It also does not hurt to build in some flexibility and have a mechanism in the investment agreement allowing a majority of the incoming investors (by capital or per capita) to waive their milestones, or to adjust them mid-course, if both the investor majority and founders deem this desirable. *Mahendra Ramsinghani* summarizes the best attributes of milestones in 'The Business of Venture Capital': "As with most terms, flexibility, speed, and simplicity are the keys to a successful start."

> Be careful with milestones. They can help bridge a valuation gap and have a role in ventures with a lot of technical risks but on the flipside you will always have to plan with a scenario where your investor will not come through with the entire financing.

There are two options to structure a milestone-based investment:

- The investor can immediately receive as many shares as is applicable when she has paid all tranches. This is the investor-friendly approach. It is advisable to have the investment agreement illustrate what the consequences of the nonachievement of the milestone(s) and the subsequent nonpayment of the further tranche(s) shall be. From the founders' perspective, an automatic (re-) transfer of a certain portion of the investor's shares to the founders against payment of their nominal value may be appropriate.

- Alternatively, the investment agreement can foresee a number of capital increases with predefined commercial terms pursuant to which the investor will gradually subscribe for new shares in the company alongside the payment of the various tranches. Under this approach, the investor will gradually build up her shareholding and receive more and more (preference) rights as set forth in the shareholders' agreement.

3.2 Capital Increase and Financing Round New Shares

Capital Increase

To authorize the capital increase so that the investor can receive her shares, the investment agreement will obligate the existing shareholders to convene a shareholders' meeting to be held as a plenary meeting (*Vollversammlung*), waiving all requirements regarding the form and timing of the convocation, preparation, and holding of a shareholders' meeting and to unanimously and with all votes resolve the capital increase to create the necessary number of the financing round new shares (as set forth above, these shares are usually preferred shares as opposed to the common shares held by the founders). As this shareholders' resolution will amend the company's articles of association (the amount of the nominal capital of a GmbH needs to be stated in its articles of association), the resolution needs to be notarized under German law.

In such shareholders' resolution, the incoming investor will be admitted to subscribe to the financing round new shares. In addition, existing shareholders may be admitted to subscribe for new shares as well, *e.g.*, because they have exercised their *pro rata*/preemption rights. Otherwise, the existing shareholders usually undertake to waive their (statutory or contractual) subscription rights without any compensation.

In addition, the shareholders' meeting usually adopts a number of other resolutions in the context of the financing round, *e.g.*, appointment of new advisory board members, new rules of procedure for the management or the advisory board as well as other changes to the existing articles of association.

All parties should be careful about the strict German laws on the proper payment of the nominal capital for the new shares. In order to not run afoul of these provisions, which would trigger a risk of liability for the investors, the company bank account into which the nominal amounts are paid must not be kept "on the debit side" and must not be debited until the date of the filing for the registration of the financing round capital increase with the commercial register of the company.

The Financing Round New Shares

A VC will normally only subscribe to a class of preferred shares. These are shares to which certain rights attach, which are not shared by ordinary common shares held by the founders and potentially others. As already mentioned, these preference rights usually fall into two categories: financial rights and control rights. VCs require these additional rights because, in most cases, they are investing much larger sums than the founders (whose investment usually takes the form of good ideas, time and limited seed money plus the forgiveness of any meaningful social life for a prolonged period and the experience of accelerated aging) and at a much higher valuation. The VCs will usually also have little to no control over the company's day-to-day operations, in contrast to the founders, who typically remain closely involved in the start-up's management.

It is typical that in each financing round a new class of preferred shares is issued, *e.g.*, starting with preferred shares of Series Seed/Pre-Seed, followed by preferred shares of Series A and then preferred shares of Series B and then, you get the idea. Distinguishing the rights enjoyed by different series is common practice because the investments made at the time of the creation of each series are usually based on different company valuations and circumstances and, consequently, have different risk profiles.

These preferences can be set forth only in the shareholders' agreement, which has the benefit of maintaining confidentiality from the general public. It is, however, often advisable to also set forth at least certain of these rights in the company's articles of association. The latter is particularly true for special dividend rights (which are rare in Germany), rights to appoint and remove members of the advisory board and often liquidation preferences.

ZERO HURDLE GROWTH... A SHARE CLASS JUNIOR TO THE COMMON SHARES?

Every now and then one can find in the start-up's articles a class of shares that "look and feel" like common shares but that are actually economically junior to the common shares. These shares go by a number of names, ranging from hurdle shares, growth shares, zero shares to MIP shares (MIP then stands for management incentive program)[22].

For reasons that our friends from the tax team assure us are absolutely interesting, German start-ups can in most cases issue real shares to their key executives or later founders only at fair market value (we have already explained elsewhere, why the 2021 tax reform bill has not really addressed these issues, to say the least). In most cases, employees will shy away from this risk. If, nevertheless, real shares are to be issued, companies in later phases regularly resort to these growth shares. In general terms, the idea of these special share classes can be described as entitling the employees to participate only in the future growth in value of the company. Until a base value of the company is reached (in the event of a liquidation or sale), the holders on these special classes of shares only receive back the nominal capital of their shares.
For this reason, a lower value must regularly be applied to these shares compared to the value of common shares or even preferred shares.

The issuance of growth shares/hurdle shares usually requires a significantly higher structuring effort. Employees and investors must be familiar with the instrument, special rules have to be included in the shareholders' agreement and the company's articles of association. The valuation of these special shares is also regularly more complex and time-consuming. Finally, special share classes are more susceptible to audits, and additional costs can also arise in an external audit of the company or wage tax. However, with growth shares, their holders can then benefit from the lower capital gain taxation in case of a subsequent sale of the growth shares. While these shares come with some costs and complexities and the concept doesn't really scale beyond a few shareholders, they can nevertheless be an attractive option for a selected group of key executives.

3.3 Other Useful Provisions

Investor Default

The investment agreement should contain provisions addressing a scenario where the investor does not comply or has not fully complied with (i) its obligation to subscribe to its financing round new shares, (ii) its obligation to make payment of the nominal amount of the financing round new shares subscribed to by such investor, or (iii) its obligation to make additional payments into the capital reserves of the company. If the defaulting investor does not comply with its obligations within a certain grace period, the investor shall be excluded from the investment agreement, forfeit any rights to subscribe for shares, and lose any new shares it might have already acquired against repayment of any amounts paid in by the defaulting investor in the respective financing round (if any). In addition, the defaulting investor might be obligated to reimburse the company for the fees triggered by the notarization of the investment and shareholders' agreements and potentially other costs for outside advisors.

Use of Funds and no Legacy Liabilities

Investment agreements may also contain restrictions regarding the use of funds contributed by the new investor. For example, a restriction might state that unless approved by the respective investor, the advisory board or an investor majority, the proceeds from the financing round must be exclusively used for the development of the company according to the strategy and implementation plans as agreed upon by the company and the incoming investor. The new investor will especially want to make sure that its funds will not be used to repay "legacy" obligations of the company towards its existing shareholders and that the new funds are fully available to finance the growth of the company.

22 For details see our Guide *OLNS#8 OLNS#8 – ESOPs, VSOPs & Co.*, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/2021/olns-8-esops-vsops-co.pdf.

4. SECONDARY SHARE SALES

4.1 What is it?

As start-ups can raise liquidity by private financing rounds easier and therefore stay private for longer, the market for so-called "secondary purchases", or "secondaries" for short, is increasingly growing. Prolonged private companies and subsequent IPOs result in successful founders being millionaires on paper, but their company shares are hardly liquid. In this respect, founders and early-stage investors are increasingly seeing the need to sell off at least part of their shares ahead of time. The term "secondary" in this context means that one or more shareholders – typically the founders or their first backers, *e.g.*, business angels – sell part or even all of their shares to a buyer before an IPO occurs.

While secondaries are often carried out by start-ups that have recently achieved financial success and have thus become a "must-have" for investors, secondaries are not always seen as a positive signal by all stakeholders. Founders taking money off the table are sometimes seen as less committed or less sanguine with their business' future. So there might be some negative signaling effect.

There is another potential drawback of a secondary share sale by the founders or early investors. These days, start-ups can raise much higher financing rounds and stay private for much longer. This can also dilute the effects of an Employee Ownership program on employees' morale, motivation and alignment. A fact that can be further aggravated when founders and early backers (usually the business angels) decide at some point to cash in a portion of their stakes through secondary purchases as part of just another financing round. However, every now and then German start-ups voluntarily offer their employees early opportunities to take some money off the table. One recent example is the German start-up TaxFix. When that company closed a USD 65 million financing round in early 2020, a group of eligible current and former employees were offered the chance to sell a portion of their vested Stock Options (TaxFix had implemented a VSOP). According to the company, it paid a total of EUR 3.8 million as part of this early exercise opportunity to reward past performance and show that the virtual assets the beneficiaries held were of real value.

Secondary sales help the founders to de-risk a bit and can clean up the cap table. These benefits need to be balanced with a potentially reduced incentivization and occasionally a perceived unfairness in the eyes of the ESOP beneficiaries.

4.2 Structuring a Secondary

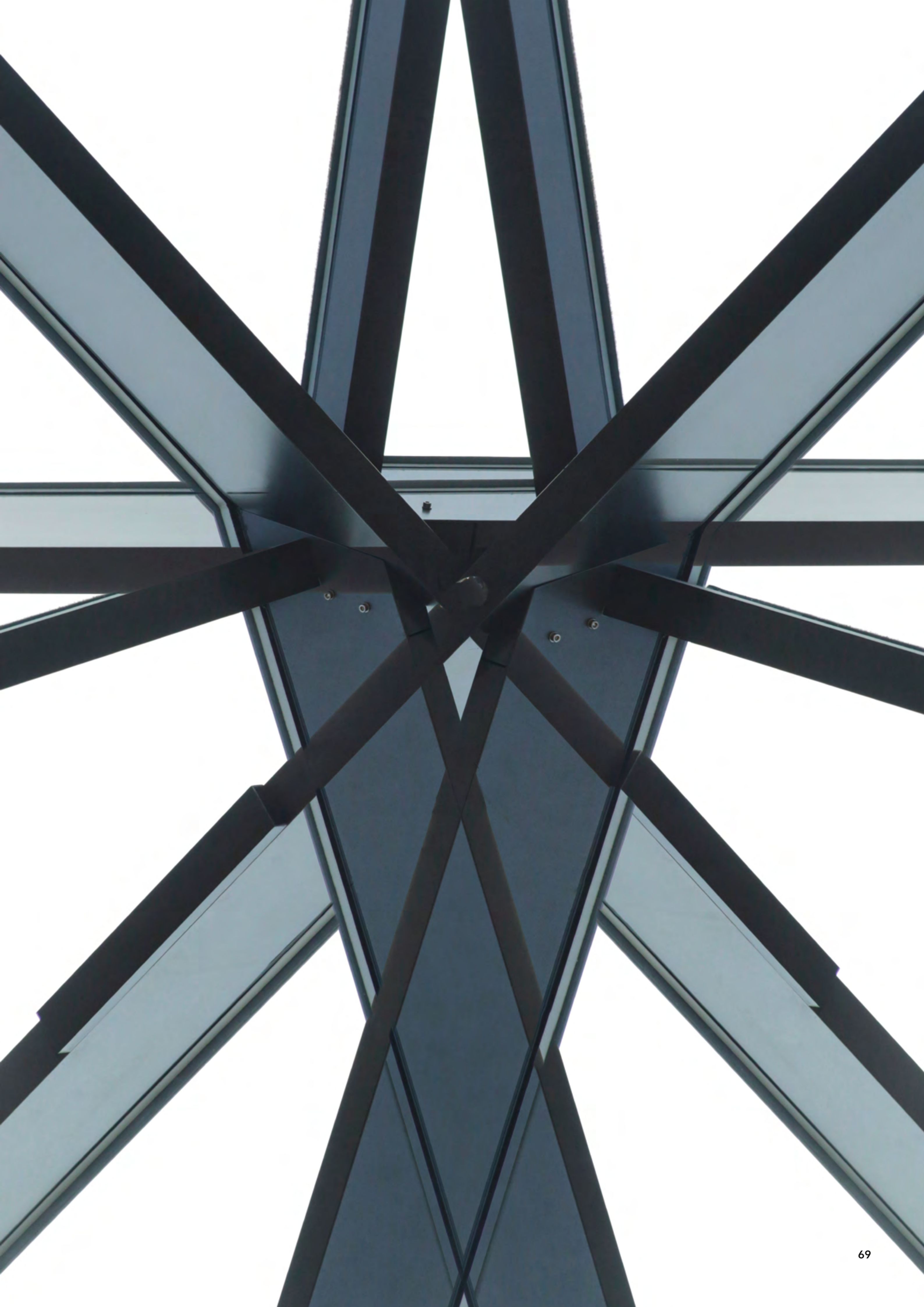
Although the basic concept of the secondaries seems comparatively simple, *i.e.*, some shareholders sell some of their shares to some of the incoming investors as part of a financing round. Simple right?

Well, first of all, many shareholder agreements contain a so-called right of first refusal. As soon as a shareholder agrees to sell her shares, the company or the other shareholders have the prevailing right to buy the shares from the seller at the terms and conditions just agreed. In addition, the co-shareholders will often benefit from co-sale rights (so-called tag-along rights) that allow them to co-sell a portion of their shares alongside the secondary seller. So, the parties to the secondary share sales will have to engage as early as possible in stakeholder management to make sure that the secondary share sales have a chance to actually go through.

As already mentioned above, the parties will also have to consider the potentially negative signaling effects of the founders taking money off the table, while the beneficiaries under the company's Employee Ownership programs will have to bite their times.

Economically most important are the questions at what price shall the secondary shares be sold and what shall happen to the shares. Keep in mind that founders will usually sell common shares and early backers will sell Pre-Seed preferred shares or Seed preferred shares. So the question arises what shall happen to the sale shares if they are sold in the course of a Series A to investors that will also subscribe for new preferred Series A shares as part of their primary investment:

- We often see secondary sale shares to be sold at a 10-20% discount off the prevailing share price of the respective financing round, *e.g.*, if new preferred shares of Series A are issued as part of the Series A primary financing at a price of EUR 100, then the secondary shares (*i.e.*, usually common shares or shares of Series Seed or Series Pre-Seed) will be sold at a price of EUR 80 – 90 per share. Obviously, the discount will reflect competitive dynamics and we have seen quite a number of secondaries where new investors were so eager to get in on the action that they paid the full price of the financing round even for shares of a lower class.
- Finally, the question needs to be answered if the secondary sale shares will be upgraded to the preferred shares of the current financing round or stay common shares or preferred shares of Series Seed or Series Pre-Seed (as applicable). As a general rule, unless all existing shareholders will have a chance to participate in the secondary share sale, they will usually be reluctant to agree on any such upgrade as such upgrade (which comes with the benefits of liquidation preferences, antidilution protection etc.) will dilute the economic value of their own stake in the start-up.



5. REPRESENTATIONS, WARRANTIES AND REMEDIES

5.1 Representations and Warranties in VC Financings vs. M&A Transactions

VCs will expect appropriate representations and warranties to be provided by the founders (at least in the earlier rounds) and the company, as well as the existing shareholders, though the latter usually only to a limited extent with respect to their shareholdings and a few other so-called "fundamentals". The primary purpose of the representations and warranties is to provide the incoming investor with a reasonably complete and accurate understanding of the current status of the company, its technology and business as well as past history and general legal risk profile so that the investor can make an informed decision about whether it wants to invest.

> Venture capital financings are not just smaller-scale M&A, and representations and remedies should be viewed against this background. However, founders live in a reputation economy and should take the entire representations and disclosure matter very seriously.

However, when negotiating representations, warranties and remedies, all parties should keep in mind that financing rounds differ from a classical merger and acquisition transaction. Venture capital financings are not just "M&A with a capital increase", and concepts that have been tried and tested in cases where a tech company is sold to an acquirer in basically a one-off transaction might not be appropriate for a venture capital financing where the parties engage in a "marriage for a certain period of time". This holds true for, among others, the representations, warranties and remedy concepts. While in M&A transactions there are often extended catalogues of thorough representations and warranties (these parts of the transaction documents seem to be the lawyers' favorite playground), they tend to be less relevant (though not necessarily less long...) in venture capital financings for the following reasons:

- Lack of maturity of the target company and uncertainties around the company's products and business model/profitability;
- Risk profile of the investor, as institutional investors usually only invest during the early stages rather small amounts of money, take minority positions and have a portfolio of investments (oh, and yes, they are investing *venture* capital);
- New investors will often invest alongside existing financial backers of the company;
- Unlike in a buyout scenario, the risks of owning a stake in the company are not entirely passed on to the new investor;
- Guarantors (particularly the founders) will likely not have deep pockets; and
- The survival period for representations and warranties will often be rather short for practical purposes, as in the next financing round, the then incoming investor will be keen to have any legacy representations and warranties being waived as otherwise the new investor would, through its investment, at least partially, pick up the bill.

That being said, investors will (and should) request their representations and warranties. They are investing either their own or, as trustees, third-party funds, and they need to confirm their understanding of the target company after their due diligence. However, in many cases, the founders will not have particularly deep pockets, and unlike in an acquisition scenario, they do not cash in as part of a normal financing round where the new funds flow to the company but not to the founders. In addition, unlike in the M&A arena, we have hardly ever seen VCs initiate court or arbitration proceedings for an alleged violation of representations and warranties. This has been confirmed to us by representatives from the German Institute of Arbitration (*Deutsche Institution für Schiedsgerichtsbarkeit e.V. – DIS*), who could not recall any significant number of arbitration procedures under the DIS rules that were initiated by VCs in Germany so far. Our guess is that if VCs feel that representations and warranties have been breached and an amicable settlement with the founders cannot be reached (*e.g.*, giving the investors extra shares), they will, in most cases, simply walk away from their investment and refuse to provide additional financing in subsequent rounds.

We recommend that investors act with a sense of proportion. Threatening the founders with huge liability risks – remember, the founders that are meant to build the next big thing – is not a good way to start a partnership. Careful venture capital lawyers will negotiate a reasonable set of representations and warranties that can be expected to be given by any founder acting in good faith and that primarily serve as a "hygiene factor". Add in some materiality qualifiers, knowledge qualifiers and thresholds for disclosure so that immaterial violations do not result in breach of the financing agreement, and such discussions should not cause unnecessary and potentially long-term friction and mistrust.

On the other hand, it is paramount for the founders to take the representations and warranties they and their company give extremely seriously and work with their lawyers diligently to prepare disclosure schedules. Do not try to hide anything. While a founder may not necessarily have to worry about a huge courtroom battle and subsequent financial losses, a reputation of "outsmarting" one's own investors will spread quickly and doom any serious entrepreneur's prospects.

5.2 Examples for Representations and Warranties

The scope of the representations and warranties that an investor requests will depend on a number of factors, not only including the investor's risk appetite, but also the state of the company's development. For example, for a very early-stage funding round, extensive representations and warranties on agreements with customers and suppliers or the company's IP portfolio might be moot, while they may make more sense in later-stage financings. Here are some examples of matters that are often subject to representations and warranties:

Legal Capacity

- Sufficient power and authority of the company to conduct its business and to consummate the financing round; and
- No violation of applicable law or contractual obligations of the company by entering into the financing documentation.

Status of the Company and Shares

- Proper incorporation of the company, including compliance with applicable capital maintenance rules (*Kapitalaufbringung und Kapitalerhaltung*);
- No third-party is entitled to control the company or participate in its profits;
- No insolvency of the company;
- Ownership of the shares in the company and no encumbrances/third-party rights on company shares;
- No other shareholders' agreement and trust or similar agreements regarding the shares in the company; and
- No options, warrants or similar rights (including conversion and preemptive rights) other than as contemplated under the investment and shareholders' agreements or the articles.

Financials

- Preparation of financial statements in accordance with German GAAP;
- No off-balance sheet liabilities and no credit liabilities;
- Management accounts, if any, having been properly prepared from the books of the company and representing a fair view in all material aspects.

Intellectual Property Rights and Information Technology

- Ownership and absence of third-party rights regarding own IP rights;
- Sufficiency of owned and licensed IP rights to operate the company's business;
- No infringement of own IP rights by third parties;
- No infringement of third-party IP rights;
- Compliance with employee invention laws and transfer of IP rights from freelancers and consultants;
- Adequacy of existing information technology and no major breakdowns in the past;
- Protection of know-how, if any; and
- Use of open source software, if any, in compliance with applicable license rules.

Licenses, Compliance, State Aids and Litigation

- The company holds all necessary public permits and has acted in compliance with them;
- Compliance with applicable (material) laws;
- Disclosure of all subsidies, allowances, grants and any other state aid received by or granted to the company and compliance with their terms and conditions; and
- Absence of (material) pending or threatened litigation.

Material Agreements

- Disclosure of certain material agreements, *e.g.*, loan agreements, guarantees and suretyships, joint ventures, agreements with main customers and suppliers, agency agreements, agreements containing non-compete restrictions; and
- No termination of material agreements and no violation of terms of material agreements.

Privacy and Cyber Security

- Compliance with applicable privacy laws (in all material aspects); and
- No privacy incidents and leakages within last three years.

Employment Matters

- Complete list of all employees, interns and freelancers;
- No termination of or by key employees;
- Compliance with applicable laws regarding *de facto* employment (*Scheinselbständigkeit*) and minimum wages (*Mindestlohn*);
- No pension schemes; and
- Collective bargaining situation, if any.

Tax Matters

- Compliance with tax filing and tax payment requirements; and
- Proper bookkeeping.

Other (if applicable)

- Real estate and material fixed assets;
- Insurance coverage and insurance claims history;
- Fair (and complete) disclosure of information in the investor's due diligence;
- Product safety and warranty obligations; and
- Compliance with special regulatory requirements (*e.g.*, in case of insurtech or fintech start-ups).

5.3 Remedies

The investor expects the guarantors (*i.e.*, in most cases the company and the founders for the operational and finance-related representations and warranties and all shareholders for the title representations and warranties) to back up their representations and warranties with a contractual obligation to compensate the investor in the event that the representations and warranties are inaccurate. An investor-friendly way would be to simply agree that the investor shall be entitled to compensation in accordance with sects. 249 *et seq.* German Civil Code if a representation and warranty has been breached. Under these rules (which are not mandatory and from which the parties can deviate by contractual agreement), the guarantors would be liable for all direct and most indirect and consequential damages without a liability cap. Thus, the parties are usually well advised to agree on more nuanced remedy provisions in the investment agreement that are more tailored to the specific case at hand and designed to limit the exposure of the guarantors.

The extent of these limitations is up for negotiation when documentation is being drawn up and varies according to the severity of the breach, the size of the investment, and the financial resources of the guarantors and the relative bargaining strength and risk appetite of the investor, although, according to our experiences in recent years, when funding was relatively easily available, certain rather guarantor-friendly standards have started to emerge.

Frequent compromises in the remedy section:

Losses = direct damages and foreseeable indirect damages but excluding lost profits;

De minimis of 0.1% of the investment amount and a tipping basket of 1.0%;

Survival period of 18 months for operational and 3 to 5 years for fundamental representations; and

Cap on the personal liability of the (active) founders equal to 1-2 x their annual gross/net cash salary (caps can be higher if the founder got some liquidity by means of a secondary share sale).

In the remainder of this section, we present some of the most common indemnification points found in (more complex) investment agreements. However, keep in mind that under mandatory law, the liability of a guarantor in case of willful misconduct (*Vorsatz*) cannot be excluded or limited. Thus, guarantors should take the representation and warranties exercise very seriously, seek proper legal advice and make disclosures to the best of their knowledge.

With respect to representations and warranties given by the company, the restrictions on payments to shareholders under mandatory German law must also be observed. Such restrictions prohibit certain payments by a company to its shareholders and will, among other things, require that the responsibility of the company is limited if and to the extent that, as a result of such liability, the company's net assets fall short of the company's registered share capital or such shortfall is increased (*Begründung oder Vertiefung einer Unterbilanz*).

Definition of Losses

In the event of a breach of any of the representations and warranties, the guarantors are usually given the opportunity – within a certain period of time – to put the investor in the position the investor would be in if the respective representation and warranty had not been breached. For the legally minded (we know, but leave us the illusion) this is called a restitution in kind (*Naturalrestitution*).

If such restitution is not possible, has not been timely made or is not sufficient to compensate the investor, the guarantor will be obligated to compensate the investor in cash for losses suffered by the investor (for alternative compensation methods, please see below).

The investment agreement will usually provide for a definition of which kind of losses must be compensated. While we often see that lost profits are excluded and that the investor is prevented from calculating its losses based on multiplier valuations or the like, it is subject to negotiation whether or not to include (other) indirect and consequential damages, legal expenses, etc., into the loss definition.

Exclusion of Liability

The investment agreement will contain a number of further limitations on the guarantors' liability, such as the examples set forth below; though such limitations usually do not apply to the more "fundamental" representations and warranties (in particular, regarding status of the company and shares in the company).

Often an investor will not be entitled to be compensated if:

- The investor already knew about the underlying facts, circumstances or events forming the basis of the claim at the time the investor signed the investment agreement, or the facts, circumstances or events were fairly disclosed to the investor in the disclosure schedule attached to the investment agreement or documents provided in the data room – here, US and German market usances differ, while in the US usually only the specific disclosures made in a disclosure letter are relevant, in Germany, it is customary to have specific disclosures in the disclosure schedules attached to the investment agreement and in addition have the contents of the data room be considered disclosed (at least if the data room disclosure lives up to a more or less strictly defined "fair disclosure" standard);
- The matter was taken into account as a deductible in the pre-money valuation (note that this exclusion will often require preparing a document setting forth how the parties came up with the pre-money valuation and what deductibles, etc., they had already factored in that calculation); or
- The loss results from the passing of or any change in, any law, rule or regulation following the signing date.

De Minimis and Basket

The Investor will often agree that:

- It will only be entitled to bring a claim for loss if the loss exceeds a certain *de minimis* threshold (*e.g.*, 0.1% of the investment amount – the *de minimis* is almost always a threshold and not a deductible); and
- It will not have recourse against the guarantors until all its claims that each exceed the de minimis will exceed (in total) an agreed-upon threshold amount (*e.g.*, 1% of the investment amount). Sometimes this amount is a "tipping basket" (once the amount is exceeded, the investor is entitled to be indemnified for all damages, back to the first EUR), and sometimes it is a "true deductible" (the indemnity is limited to amounts over the threshold).

Note that the *de minimis* and basket usually do not apply to the fundamental representations and warranties.

Caps

The guarantors will seek a cap on their indemnification obligations. Such caps usually differ depending on which guarantor stands behind the representation and warranties.

- Claims under representations and warranties given by the company are often capped at a certain percentage of the investment amount for operational representations and warranties and a higher percentage (up to 100%) for the fundamental matters.
- The investor should keep in mind that the founders will often not have cashed in during the financing round (unless there has been a small secondary buyout in the course of which the founders have sold a small stake in the company to the investor) and will not have deep pockets to pay any damages in cash. While each situation is different, we think that in many cases it makes sense to cap founders' personal liability at an amount of once or twice their annual salary (gross or net). This number is in line with current market trends, and it should usually be still a significant risk that should motivate the founders to make proper disclosures.

In addition, keep in mind that in later financing rounds (usually starting from Series B onwards), the operational and financial representations and warranties are often only given by the company and no longer also by the founders.

Survival Periods

The guarantors will seek the indemnification obligation to terminate at some designated point after the closing of the financing round.

Survival periods of 12-24 months for the "operational" representations and warranties and three to five years for the fundamental representations and warranties are customary. For tax matters, the survival period sometimes expires three to six months after (i) expiry of the period for the assessment of the relevant tax underlying the claim or, (ii) to the extent that the tax is not assessed as per the relevant jurisdiction, expiry of the period for the enforcement of such tax. The latter is, however, often more appropriate in an M&A context while for simplicity's sake the limitation periods for tax-related representations and warranties are often the same as for the other financial representations and warranties.

Form of Compensation

In addition to a claim for cash compensation, these days the investment agreement will often also provide for an alternative compensation mechanism, *i.e.*, compensation in equity by giving the investor additional shares.

The rationale for this alternative compensation mechanism is that the loss-making start-up will usually need the cash injected by the investor to fuel its growth so claiming the repayment of a portion of these funds seems counterproductive from the investor's perspective.

A compensation in equity can be implemented by means of a so-called compensatory capital increase. Based on the severity of the breach of the representations and warranties, a reduced pre-money valuation of the company is calculated, and the investor receives as many additional shares as are required to put the investor in the position it would be in if the investor had invested on the basis of this reduced pre-money valuation. This will obviously dilute the existing shareholders and depending on the seriousness of the breach of the representations and warranties, the investor might not be interested in getting more shares in a company in which it might have wished not to have invested in the first place. Hence, the parties will need to find a compromise on who (company or investor) can decide whether a compensation in cash or in equity shall be made in case of an uncured breach of a representation or warranty.

The provisions presented in this Chapter seek to provide some economic downside protection to the investor. Unlike the other economic provisions discussed above, the following clauses can usually be found in the shareholders' agreement rather than the investment agreement.

6. FINANCIAL PROTECTION OF THE INVESTOR

6.1 Antidilution

Investors often require antidilution protection rights, sometimes also called down round protection. Dilution of the investor's ownership percentage in the company is a natural occurrence in growth companies if investors do not participate in each financing round (to avoid such a dilution, investors seek preemption rights). What venture capital typical antidilution clauses attempt to protect the investor against is, however, devaluation of the investor's ownership through a price-based dilution.

Rationale for Antidilution Protection

If new shares are issued at a lower subscription price than the investor had originally paid for its shares, *i.e.*, a financing round at a lower pre-money valuation than the previous one, or a so called down round, antidilution clauses protect the value of the investor's stake in the company. The investor will argue that it had paid a higher price for its shares at a time when there was less information about the company's prospects and "real" value available and that it is unfair to economically dilute its shareholding now that it turns out that the share price in the prior round was too high and that the share price of the down round should be more representative for the company's value.

This protection usually works by applying a mathematical formula to calculate a number of additional shares which the investors are entitled to in order to economically compensate the dilution. Antidilution clauses come in a variety of forms. The most common ones are described below. The "right" antidilution depends on the specific case at hand.

However, very investor-friendly antidilution clauses in early rounds can be a concern for the incoming investor in a down round, as they leave little ownership for the founders as well as the managers and key employees of the company (as described above in Chapter A.III.2., Stock Options derive their value from the value of a common share). Savvy investors understand that founders usually have only one way to get rich, the horse they are riding, and we have seen quite a few cases where the incoming investors drive renegotiations between the founders and the existing investors, requesting a (partial) waiver of an overly harsh full ratchet antidilution.

Implementation

There are two ways to implement an antidilution protection:

- The shareholders' agreement can contain an obligation of the founders to transfer a certain number of shares to the investor entitled to the antidilution protection against a cash payment of their nominal value or no consideration at all. This approach is rarely implemented anymore these days as it requires a notarial share and transfer deed between the (often grudging) founders and the investor. It also triggers other practical problems in cases where founders have left the company, and now the remaining founders have to shoulder the entire burden of the antidilution clauses. So, this approach should be avoided.
- In most cases today, the investor receives additional antidilution shares (that bear the same rights as the shares that the investor has subscribed for in the original financing round) that are created by means of a share capital increase against cash payment of the nominal value of the new shares, *i.e.*, only their par value but without additional payments into the capital reserves of the company.

DIFFERENCES FROM US INVESTMENTS: IMPLEMENTATION OF AN ANTIDILUTION PROTECTION

While both German and US market antidilution provisions, if triggered, result in the investor acquiring additional shares in the Company, most US venture deals structure an antidilution provision as a conversion price adjustment for the previous series of preferred shares. While the initial conversion ratio from preferred to common shares is 1:1, the investor will, following an antidilution protection, receive additional common shares in exchange for its preferred shares upon conversion. It is structured like this in the US in part to avoid deemed dividend issues. This adjustment attempts to stabilize the investor's percentage ownership despite the dilutive round. The conversion rate is of vital importance to venture capital investors in US deals, as shareholders will generally vote on an "as converted basis to common stock" basis. Likewise, a company's preferred shares will almost always be converted into common shares prior to an initial public offering, making an investor's total return in the event of such a public offering directly related to the number of common shares that an investor will hold after conversion.

Scope of the Antidilution Protection – Full Ratchet and Weighted Average

There are several variations of the antidilution formula to calculate the number of additional shares the investor is entitled to in case of a down round, differing by the magnitude of the number of additional shares to be given to the investor. Each provides a different amount of protection for the investor. We will start with the weighted average method first as this has been the most common one in recent times and then move on to the full ratchet method that is rarely seen these days in "normal" financing rounds but often comes back into fashion in times of crisis or in structured recapitalization/ turn-around scenarios.

(Broad- and Narrow-Based) Weighted Average: "Weighted average antidilution" is a more balanced approach to antidilution that provides some compensation for the dilution but – unlike the full ratchet described below – allows the ownership percentage of the investor to decrease somewhat. One of these is the broad-based weighted average formula, which we saw most often in recent years.

The weighted average formula adjusts the number of shares of an investor protected by the antidilution provision based on both (a) the issuance price and (b) the number of equivalent shares issued by the company after the issuance of shares entitled to the antidilution protection. There are various ways of expressing the formula, but it comes down to the same central idea: the investors' subscription price is reduced to a lower number than it was in the financing round preceding the down round, but it also takes into account how many shares (or rights) are issued in the dilutive financing. If only a few shares are issued in the down round, then the subscription price does not move much; if many shares are issued – that is, there is in fact real dilution – then the price moves accordingly.

Weighted average antidilution clauses again come – roughly speaking – in two forms:

- The broad-based is the most founder friendly and based on the weighted average of all shares (common and preferred) plus outstanding Stock Options and warrants and other convertible instruments. The purpose behind this definition is to include all shares that are already subject to issuance thereby reducing the magnitude of the antidilution adjustment.
- The narrow-based approach lies between the broad-based weighted average and the full ratchet and usually disregards the outstanding Stock Options, warrants and other convertible instruments (and sometimes other classes of preferred shares).

There are again numerous variations of these approaches. Among them is the broad swing-based, which adjusts the subscription price on the basis of the broad-based weighted average but also takes into account issuances of new shares in subsequent financing rounds that are both up and down rounds. Investors often resist this approach as it takes away some of the antidilution protection the investor received in a down round in a subsequent up round.

Full-Ratchet: Under the full ratchet protection, investors will maintain the full percentage ownership at the same level or at the same value in down rounds. In other words, the investor is put in the same position the investor would be in if it had made its entire investment on the valuation of the down round, *i.e.*, the full ratchet converts the price of all the previously subscribed shares of the investor to the price of the current (down) round. In the terminology of US VC deals, the conversion price for which preferred shares can be converted by the investor into common shares is ratcheted down.

Sample Calculation (Anti-dilution Protection)

Scenario: The Series A financing round has been completed based on the following parameters	
Series A pre-money valuation	EUR 35,000,000
Outstanding Share Capital prior to Series A	EUR 25,000,000
Series A share price	EUR 1,400.00
Investment by Series A Investor	EUR 10,000,000
Number of Series A shares issued to Series A Investor	7,143 (equal to 22.22%)
Series A post-money valuation	EUR 45,000,000
Outstanding Share Capital after Series A	EUR 32,143.00

After completion of the Series A financing round, a down round occurs with the following parameters	
Down round pre-money valuation	EUR 20,000,000
Down round share price	EUR 622.22
Investment by down round Investor	EUR 5,000,000
Number of down round shares issued to down round Investor	8,036

Number of shares to be issued to Series A Investor under Anti-dilution Protection, in case of...

	WEIGHTED AVERAGE DILUTION PROTECTION		FULL RACHET DILUTION PROTECTION	
Formula	$S = \left(\frac{(K1n \times P1)}{WAP}\right) - K1n$		$S = \left(\frac{(K1n \times P1)}{P2}\right) - K1n$	
	Whereas			
	$WAP = \left(\frac{(K1n \times P1) + (K2n \times P2)}{(K1n + K2n)}\right)$			
Caption	**K1n =**	Number of shares issues to Series A Investor	**K1n =**	Number of shares issues to Series A Investor
	P1 =	Series A share price	**P1 =**	Series A share price
	K2n =	Number of shares issued to Down Round Investor in down round	**P2 =**	Down round share price
	P2 =	Down round share price		
		WAP = 988.23		**P2 = 622.22**
Number of shares to be issued to Series A Investor under Anti-dilution Protection	2,976		8,929	

Considerations and Compromises

The full ratchet is the most investor-friendly option and investors might argue that it is appropriate in uncertain times as it addresses mispricing in what could be a deteriorating market or one where it is hard to know where things will go. However, parties should be aware that full ratchet has a real impact on the holders of common shares and founders and management will likely consider it draconian. The main argument against this approach is that it can be very harsh on the founders if the company raises only a relatively small down round, *i.e.*, the price-based dilution is rather small. For the full ratchet, it is irrelevant whether the company raises EUR 500,000 or EUR 50,000,000 in a down round, as the investor's subscription price from the earlier round is reduced all the way to the price of the down round in either case. In addition, a full ratchet may not always be in the investors' best interest. This holds true if there is not a single investor but a club deal in which a group of investors with one lead investor invests in the company. If this group of investors is protected under a full ratchet provision, and if there is no pay-to-play condition, there will be little incentive for the smaller investors to participate in a down round as their investments will be fully protected against any price-based devaluation. This might leave the lead investor (who has the most money on the line) with the burden of continuing to finance the company. In addition, any incoming investor will be wary of the detrimental effects of a full ratchet on the founders, which might exacerbate an already difficult financing situation.

Against this background, the parties might compromise on the narrow-based weighted average as middle ground. There also several ways to soften the impact of any anti-dilution provisions, a few of them will be presented below. Whether or not they make it into the financing documentation is a question of the bargaining strengths and risk appetite of the parties involved.

Pay-to-Play: A provision that has fallen a bit out of fashion in the recent years is a pay-to-play. Pay-to-play provisions are sometimes requested by founders and existing backers from new investors in exchange for granting them more preferential rights. The provision requires the investor to participate in subsequent financing rounds (pay) to avoid forfeiting certain rights (keep playing), such as antidilution protection, veto rights or the right to appoint members of the board. Pay-to-play provisions come in different levels of intensity, *e.g.*, softer versions provide that a non-participating investor shall forfeit (i) only parts of its preferred rights or (ii) all of its preferred rights, but only temporarily until (and if) the investor subscribes for its *pro rata* portion of new shares in any of the next financing rounds. Although the latter might be preferable from the perspective of the respective investor, it can make future financing rounds a bit more complex when there are many reemerging legacy provisions to take care of.

While there is a general argument for pay-to-play provisions, as they require the investor to stand up at the time of its initial investment and economically commit itself to support the company through its life cycle, pay-to-play needs to be squared with the dynamics of the existing and potential future investors. Adding a pay-to-play provision in a later-stage financing round with new investors can be difficult to implement. In this case, adding a pay-to-play could be understood as a signal that existing investors will not be willing to support the company in future financing rounds, thus the need for a pay-to-play. On the other hand, pay-to-play provisions may be inappropriate in very early rounds when the early-stage investors are angels or micro VCs that cannot be expected to participate in future financing rounds. Requesting a pay-to-play would penalize these very first backers of a company who bear the most risks early in the company's life cycle. Our general advice is to be careful with preference rights for very early-stage investors and to compensate them for their higher risks more through an appropriate valuation of the company than through too many preference rights. If the investor insists on a full ratchet antidilution protection, a pay-to-play covenant can help to mitigate some of the problems summarized above.

Event- or Time-Based Expiration: In recent founder-friendly financing rounds, we sometimes saw clauses according to which the antidilution protection automatically expires after the next financing round, provided that such next financing round is not a down round. The rationale behind this mechanism is that the antidilution clause should only provide a downside protection through the next funding event. This assumes that the parties were too optimistic at the time of the investment and – due to a lack of information about the future development of the company and the markets at that point in time – agreed on a valuation above what the market would support with the benefit of hindsight. If the prior price is validated in the next round, then there is no need for further protection for that round as the antidilution clause is not intended to permanently reallocate the risk of any future development of the company to the founders.

Based on similar arguments, the antidilution protection can also lapse after a certain period of time, *e.g.*, 12-18 months following the financing round (irrespective of whether or not, and how many, financing rounds might occur during that period of time).

Compromise in a Downturn: Although the current state of the venture capital financing landscape makes this hard to believe, *Bob Dylan* knew that "the times they are [eventually...] a-changin". So once the bargaining power will shift more to the investor side, a potential compromise could be to give the investor a full ratchet antidilution protection for the first 12 months after the financing round and have the antidilution protection then automatically switch to a (narrow-based) weighted average concept.

Some other Tips: In addition, we would advise the parties to also include a right of the majority of the class of preferred shareholders who are entitled to the antidilution protection to waive the antidilution protection for the entire class. This is helpful when the majority of the investors of such class is willing to further invest in the company. If a down round affects several series of preferred shares, *i.e.*, triggers anti-dilution rights for the various classes, the situation can get complex. Here, it is often advisable to attach sample calculations to the shareholders' agreement for information purposes. Also keep in mind that if one investor acquires shares against a cash consideration and another against contribution of a convertible loan, their benchmark prices to determine whether a subsequent financing round is a down round should be different, as convertible loan agreements often provide for discounts or valuation caps upon conversion.

6.2 Preference Dividends

A common feature of US and UK venture capital investments are preferred dividend rights. So far, this concept hasn't really gained much traction in Germany and we don't see it that often.

A preferred dividend right is a preferential, cumulative dividend, usually fixed at a percentage of the purchase price paid for each preferred share (*e.g.*, 6%) to be paid to investors upon company exit. Though not as common in the German market, founders should expect such requests from later-stage English or American investors, particularly when they have a private equity background.

The rationale behind this preference right is the following: VCs invest in high-growth companies and aspire to a multiple return on their investment upon occurrence of an exit event. Even if these high-growth companies should make profits prior to the exit, most often it makes more sense from an investor's perspective to reinvest the profits rather than to pay out dividends. The company will also be prevented from paying any dividend to other shareholders until the preferred dividend is paid. If that dividend cumulates until an exit (which will be a standard investor request), it effectively prevents any other dividend being paid until then. In addition, an investor majority will often have an overriding right to veto the payment of any dividend. In economic terms, the larger the investment amount and the lower the expected return multiple in an exit, the more preferred dividend rights matter. In addition to a dividend preference, VCs typically require that the preferred shares be entitled to participate in any distributions on the ordinary shares. This means that preferred shareholders would enjoy a *pro rata* share of any dividends paid to the holders of common shares on top of their preference right.

6.3 Liquidation Preferences

But let us get back to another really important economic provision, the liquidation preference.

> For those of you in a hurry and who never read anything that can't be finished over an espresso: In the current environment, anything other than a one-time non-participating liquidation preference requires a good justification. (See, there should be even some espresso left for you to read another paragraph).

A common feature of VC investments is a liquidation preference. Though they come in many forms – and we will discuss some variations below – liquidation preferences impact how proceeds are shared among the shareholders in a liquidity event, as they entitle the investor to receive a certain amount of the liquidation proceeds "off the top" and before holders of common shares. This preference amount may be equal to the amount of the preferred shareholders' investment (*i.e.*, price paid per each respective preferred share) or a multiple of it. All liquidation preferences have the goal of protecting the investor's investment in case of lower liquidation/exit values. Depending on how it's structured, it may also increase the investor's return at exit.

Brad Feld and *Jason Mendelson*, in their insightful book 'Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist' (bet you love the title, but seriously, this book is highly recommendable) call liquidation preferences "a dark art", alluding to the impact they may have on the "real" economic ownership of a company. For founders and investors alike, it is very important to understand the economics of multiple layers of liquidation preferences and their consequences for founders' incentives.

As we will see, liquidation preferences have a big impact when liquidity events yield less than the invested capital and a smaller impact when liquidity events yield more than the invested capital. There are three key features that make up a liquidation preference:

- When does it apply?
- What is the amount of the preference?
- Is the liquidation preference a "real" economic preference or do the holders of common shares benefit from catch-up rights?

Scope of the Preference – Liquidity Events

Despite its name, the liquidation preference is relevant in any kind of exit transaction in which shareholders "cash in". In most agreements, the liquidity events include not only the dissolution and liquidation of the company, but also the occurrence of an exit, usually defined as a majority sale of the company or the majority of its assets (for details of exit provisions, see below under Chapter A.IV.4.4). Economically, one can think about such exit cases as deemed liquidation events.

The drafting of the liquidation preference clause requires special attention, and it should be made clear that the liquidation preference shall benefit only investors if and to the extent they participated in the exit, *e.g.*, sold their shares. The economics of liquidation preferences in case of a staged exit, *i.e.*, a scenario when not 100% of the company is sold but the exit occurs in several unrelated stages over time, can be pretty tricky. In this context, it should also be made clear that an owner who has already received a liquidation preference should not benefit regarding the respective preferred shares from the liquidation preference again upon the occurrence of another liquidity event.

The Amount of the Preference

The amount of the preference is usually defined as a multiple of the amount invested (liquidation multiple), often expressed through the price of the preferred share paid by the investor. The multiple is an indicator of market and sector dynamics. Currently, in Germany, a 1x liquidation preference is considered the absolute standard and amounts of more than 1x have in recent years been rather exceptional. As a compromise, we sometimes saw a 1x liquidation preference with computational interest, often 6% or 8% p.a. (similar economic outcome as a preferred dividend).

Contrast this with the 3x and higher liquidation preferences we saw after the burst of the internet bubble in the early 2000s or – to a lesser extent – after the onset of the Global Financial Crisis in 2007/2008. The liquidation preferences went up when VCs became increasingly scarce and VCs had more leverage. As we have seen in the past, when times get worse, investors seek to hedge their downside risk, and one key feature is the liquidation preference. Especially in times of prolonged uncertainty with deteriorating exit prospects (due to closed IPO windows and less corporates having less appetite for start-up M&A) investors tend to pay more attention to these clauses.

Irrespective of whether the liquidation preference is structured as a fully or capped participating or non-participating preference (see below), liquidity events that yield less than the invested capital will shut out the holders of common shares (that is, in most cases, the founders) from any proceeds. The amount that needs to be returned to investors to satisfy all liquidation preferences is sometimes referred to as 'liquidation preference overhang'.

Participating vs. Non-participating Preferences

After the investor has received its liquidation preference, the question arises how the remaining proceeds (if any) shall be distributed. A crucial distinction needs to be made between non-participating and (fully or capped) participating liquidation preferences (in the German market, we sometimes also see the terminology catch-up and double-dipping for the two approaches set forth below).

- Non-participating: The most founder-friendly option is the non-participating liquidation preference (*anrechenbarer Liquidiationsvorzug*).

  In its simplest form, the holders of preferred shares get their liquidation preference on level 1 and then all remaining proceeds are distributed amongst the holders of common shares on a level 2 while the holders of preferred shares have the right to convert their preferred shares to common shares prior to any distribution. An alternative structure is that after payment of the liquidation preference amount, the holders of common shares may catch up by receiving an amount equal to the amount credited to the shareholders entitled to the liquidation preference. After that payment, the remaining proceeds will be shared on a *pro rata* basis among all shareholders.

Participating = nicht anrechenbar

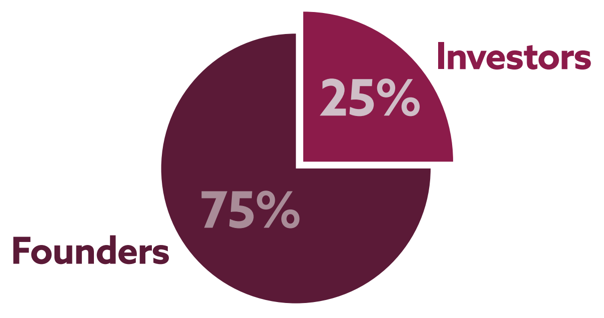
non-participating = anrechenbar

In other words, if the liquidity event yields more than the liquidation preference overhang, a non-participating liquidation preference has no economic impact on the distribution of exit proceeds.

- Participating: A more investor friendly approach is the participating liquidation preference (or as some founders call it, the double dip). After payment of the preference amounts, the remaining proceeds are shared *pro rata*, according to their percentage shareholding, among the preferred and common shareholders, *i.e.*, without a catch-up. US investors call this participation on an "as-converted" basis, which means that with respect to the distribution of liquidation proceeds, the preferred shares are treated as common shares as if the preferred had converted to common based on the applicable conversion ratio (initially 1:1).
- Capped Participations: One potential compromise are capped participations. These indicate that the preferred shares will receive the liquidation preference and then participate in the distribution of the remaining liquidation proceeds on an as converted basis but only up to a certain cap, usually a certain multiple return on the investment made by the investor on these preferred shares, for example a 3x.

Sample Calculation (Non-participating Liquidation Preference)

Investment Round Facts:	
Investment:	10.0m EUR
Pre-money Valuation:	30.0m EUR
Post-money Valuation:	40.0m EUR
Post-closing Cap Table:	



Example:

1.5x Non-participating Liquidation Preference, *i.e.*, in case of an exit, the investor will receive the higher of (i) 1.5x its investment amount or (ii) its *pro rata* share

Exit Proceeds		**10.0m EUR**	**20.0m EUR**	**60.0m EUR**	**90.0m EUR**
Investor	1.5x Non-participating Liquidation Preference	10.0m EUR	15.0m EUR	15.0m EUR	15.0m EUR
	Pro rata	2.5m EUR	5.0m EUR	15.0m EUR	22.5m EUR
Founders		0	5.0m EUR	45.0m EUR	67.5m EUR

Example:

1.5x Participating Liquidation Preference, *i.e.*, in case of an exit, the investor will in any case receive 1.5x its investment amount and **additionally** its *pro rata* share of the remaining proceeds

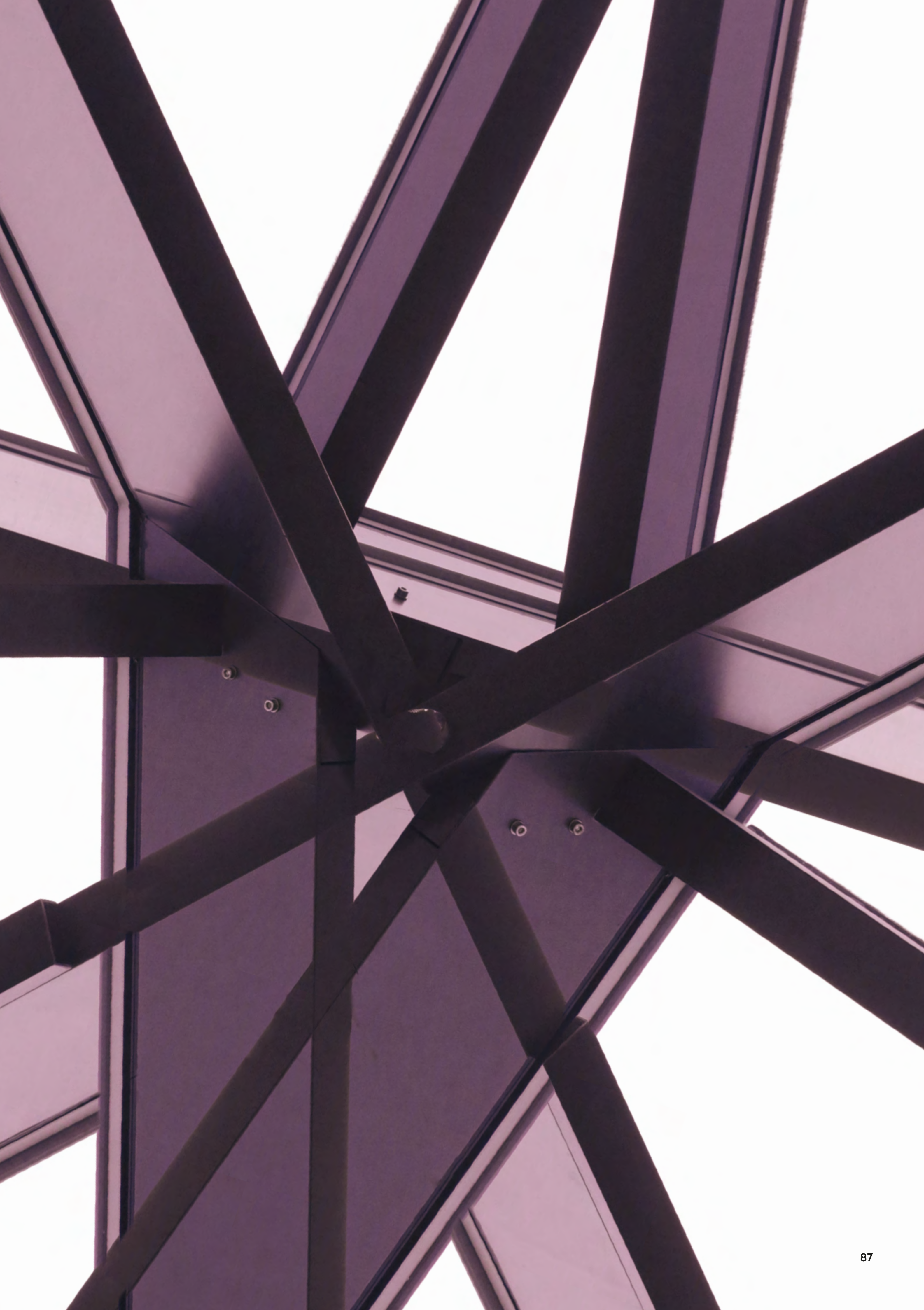
Exit Proceeds		**10.0m EUR**	**20.0m EUR**	**60.0m EUR**	**90.0m EUR**
Investor	1.5x Non-participating Liquidation Preference	10.0m EUR	15.0m EUR	15.0m EUR	15.0m EUR
	Pro rata of remaining proceeds	0	1.25m EUR	11.25m EUR	18.75m EUR
	Total proceeds received by investor	**10.0m EUR**	**16.25m EUR**	**26.25m EUR**	**33.75m EUR**
Founders		0	3.75m EUR	33.75m EUR	56.25m EUR

Layers of Liquidation Preferences – *Pari Passu* and Senior Preferences

What happens if the company raises various rounds of financing and the investors receive preferred shares with liquidation preferences in each round? There are two approaches:

- Blended Liquidation Preferences / *Pari passu* Rights. The simplest approach is to treat the various preferred shares as pari passu so that for example Series A preferred shares and Series B preferred shares benefit from the liquidation preference on the same level *pro rata* based on the relative amounts to which the respective shares entitle their holders in the respective exit event.
- Stacked Liquidation Preferences / Senior Rights. Under this "last-in-first-out" approach, the follow-on investors are treated more favorably than those who came before. The most recent investors will stack their preferences on top of the preferences of earlier rounds so that for example the liquidation preference rights of the Series B preferred shares rank senior to the Series A preferred shares and will receive their entire liquidation preference before the Series A preferred shares receive any liquidation preferences.

When agreeing on a liquidation preference, investors will also need to consider situations where it is unlikely that the founders and management will receive any liquidation proceeds. In these situations, many investors will agree to put in place alternative incentive structures, in particular a so-called "Management Carve-Out Plan" that sets a fixed amount of deal proceeds aside to be divided amongst top management in order to incentivize them to effectuate an exit.



IV. Control Terms

That was quite a bit on numbers and economic stuff. Now, let us get to some topics that lawyers naturally think to be super important (or maybe we just feel more comfortable with setting up rules for other people...): Control terms. The following Chapters will present the most important control parameters of a VC investment. Obviously, VCs want to have some say in how "their" money is spent and the general direction of the company. This includes the corporate governance of the company, information and monitoring rights as well as a ton of other covenants (dealing with ESG, US tax, IP and other matters). Finally, we will also take a closer look at customary provisions around exits and share transfers.

1. CORPORATE GOVERNANCE

1.1 Overview

The corporate governance of VC-backed companies is distinct from other privately held companies or listed companies.

The corporate governance of many start-ups is characterized by the management board (*Geschäftsführung*) and the shareholders' meeting. While these two corporate bodies are mandatory, start-ups often also have an advisory board (*Beirat*), sometimes referred to as the 'board of directors' (though we don't like that terminology as it blurs the differences between a German market advisory board and the board of directors of a Delaware Inc.). The job of the advisory board is to supervise and advise the management board and, in some instances, also to appoint and remove managing directors from office.

DIFFERENCES FROM US AND UK INVESTMENTS: MANAGEMENT BOARDS VS. BOARDS OF DIRECTORS

When looking at the corporate governance of a German company from an American or British perspective, one of the most fundamental differences is that US and UK corporate law follow the one-tier approach, while German corporate law follows the two-tier approach. This difference needs to be kept in mind when talking about the "board", which has a different meaning under German corporate law. A GmbH must have a management board, which is responsible for representing the company and running its day-to-day operations. In addition, a separate corporate body called an advisory board may be established to supervise, monitor and advise the management board (in larger GmbHs, the establishment of a so-called supervisory board is mandatory). This is the two-tier structure: in Germany the management and the supervision are separated into two distinct corporate bodies.

Interestingly, companies in the UK and US have moved closer to a *de facto* two-tier system. We see this in the growing importance of nonexecutive, outside and independent directors in UK and US unitary boards. Senior executives, managing directors and managers essentially become a management tier – or the "inner circle" – and the board of directors, consisting of a majority of non-executive, outside and independent directors become the supervision tier – or the "outer circle". In this sense, the US or UK board of directors becomes more similar to a typical German market advisory board, though in practice German market advisory boards tend to have less power than US or UK boards.

While the shareholders' meeting is a mandatory corporate body, neither a GmbH nor a UG (*haftungsbeschränkt*) need to have an advisory board (see below for cases where a mandatory supervisory board (*Aufsichtsrat*) – this needs to be distinguished from an advisory board – has to be established). Although good corporate governance is company-specific and depends, *inter alia*, on how approval rights are allocated, it is often advisable to establish an advisory board and allocate certain powers that would otherwise vest with the shareholders' meeting to the advisory board. Generally, we recommend having approval rights for more operational matters fall under the authority of the advisory board, while potentially reserving approval of more material fundamental and strategic matters for the shareholders' meeting.

- The advisory board can be controlled by the investors, in particular but not necessarily after a couple of financing rounds. In a non-investor-controlled advisory board, it is not uncommon to give the investor appointed members of the advisory board certain special veto rights with respect to material business decisions.
- The shareholders are responsible for deciding upon certain more structural matters, such as capital increases, changing the legal form of the company, amending the articles of association or establishing employee participation programs. As we will see, it is a common feature in VC-backed companies in Germany that certain of these matters also require – in addition to any majority or form requirements under applicable German law (as the case may be) – an approval by certain investors or an investor majority (and, as the case may be, the majority of common shares).

1.2 The Advisory Board

In addition to the two mandatory bodies of the GmbH, the shareholders' meeting and the management board, shareholders should consider creating a third corporate body, the advisory board, to whom they can allocate supervisory and controlling powers. In particular, when there are many shareholders in the company, it often makes sense to transfer certain powers of the shareholders' meeting to the more flexible advisory board, which can be staffed with sufficiently qualified experts. Unless there are only a very small group of shareholders on the cap table, VCs will also push for an advisory board. Keep also in mind that the German advisory board can to a large extent be modelled to reflect a US board of directors and for many US investors this will offer a certain level of familiarity and comfort.

> Good boards don't create good companies, but a bad board will kill a company every time.
>
> [Old Silicon Valley Saying]

If a company has an advisory board, it's best to state this fact, the composition of the advisory board and the advisory board's general constitution and powers in the company's articles of association. If the advisory board is conferred with the authority to appoint and remove the managing directors of the company (in German, such an advisory board is often referred to as "strong" advisory board (*starker Beirat*)), the commercial register will need to be able to verify the effectiveness of resolutions on the appointment and removal of managing directors. To enable the commercial to make its assessment, German law requires that the members of a strong advisory board must be disclosed to the commercial register by filing and keeping updated a list of the advisory board's members.

The advisory board is not to be confused with the legally defined "supervisory board", a corporate body which is mandatory for GmbHs of a certain size (leaving nuances aside (sorry, dear friends from the employment law team) the threshold is more than 500 employees) and for all German stock corporations (*Aktiengesellschaft*) irrespective of size, and it can also be established by other corporations on a voluntary basis (though that hardly ever happens, especially not in start-up land).

As establishing a supervisory board on a voluntary basis would also mean importing the strict rules applicable for the supervisory board, it is recommended to make it clear in the company's articles of association that the voluntarily established advisory board is not a supervisory board and that the rules stipulated in the German Stock Corporation Act (*Aktiengesetz*) and the German Limited Liability Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*) for supervisory boards do not apply to the advisory board. For the avoidance of doubt, it may also be helpful to clarify the applicable liability standards for the advisory board members, *e.g.*, by including the following language: "In the exercise of their office, each member of the advisory board shall be entitled to reasonably consider the interests of the shareholder or shareholders who appointed them to the extent there is no conflict to the interests of the company. A possible liability of the advisory board members towards the company due to a lack of consideration of the interests of the company in the exercise of the competences of the advisory board shall be excluded to the fullest extent permitted by law. The liability of the advisory board members shall, in any case, be limited to intentional misconduct and gross negligence."

Composition of the Advisory Board

In order to avoid a tie, it is often advisable to have an advisory board with an uneven number of members. Three or five is often an ideal number of board members, as larger advisory boards tend to be (too) slow(er) in making decisions.

Advisory board members can be appointed by the shareholders' meeting with a simple majority of the votes cast. However, in most cases, certain shareholders, such as larger investors, key founders or certain groups of shareholders (*e.g.*, the holders of a certain class of preferred shares), are granted a right to appoint and revoke a member to the advisory board. The respective weight or power that certain shareholders or holders of certain classes of shares have, can be reflected in the number of advisory board members a shareholder or group of shareholders can appoint or whether certain advisory board members have veto rights (at least for certain matters).

SOME CONSIDERATIONS WHEN SETTING UP YOUR ADVISORY BOARD

#1: Founders need to be aware that they have skill gaps and need good mentors to help them grow their company and grow themselves into their leadership roles.

#2: A good advisory board is not just a nuisance ("Do I need to get their consent?" vs. "Is this something it makes sense to sound with my advisory board and get their insights?").

#3: The advisory board must be sufficiently experienced and diverse to allow critical thinking and real dialogue. Domain expertise and competences in sales and scaling are critical.

#4: Check a potential board member's commitment and make sure a candidate is willing to contribute the necessary time to your start-up.

#5: The board composition should be sufficiently flexible. It takes a different board to launch a start-up then to prepare it for a successful exit.

#6: When considering an even number of board members, build in a deadlock resolution mechanism.

#7: Not every shareholder needs to be represented on the advisory board, advisory boards should be lean and agile. It is often advisable to have independent board members that are sufficiently incentivized.

#8: Be aware of confidentiality and competition issues.

As important decisions are made at the level of the advisory board, smaller shareholders that do not have the right to appoint a voting member of the advisory board may have a legitimate interest in participating in the deliberations of the advisory board to stay in the loop. These shareholders can be granted the right to appoint an observer to the advisory board. Such observers have the right to attend and speak at advisory board meetings but have no voting power. In order to avoid unduly impeding the functionality of the advisory board, the overall number of advisory board members with voting rights and observers should be kept as small as possible. It may also make sense to agree on rules of procedure for the advisory board that only the voting members of the advisory board shall decide, such as whether to hold a physical or virtual meeting and how resolutions are adopted.

Finally, it often makes sense to provide for some fall-away provisions, *i.e.*, already agree now when an investor or group of investors shall lose its/their right to appoint a member to the advisory board, *e.g.*, if that specific investor's shareholding in the start-up falls below [5]%. We are sometimes surprised, how much especially early round investors and some business angels can hold tight to their advisory board seat which might render an appropriate re-balancing of the corporate governance of the company in line with its funding status and growth stage unnecessary complex.

Role and Competences of the Advisory Board

After a couple of financing rounds, start-up companies often have quite a number of shareholders, though many hold small(er) stakes. While convening shareholders' meetings and adopting shareholders' resolutions require compliance with the formal requirements set forth in the company's articles and applicable law, the rules of engagement for an advisory board can be more flexible. This is one of the main advantages to decision-making at the advisory board level. The advisory board also usually has fewer members than the number of shareholders, which facilitates discussions and improves the quality of deliberations, in particular if the advisory board has a sufficient number of seasoned experts. Experienced founders understand that the advisory board's role should not be limited to imposing discipline on the founders, but that the expertise, commitment and networks of the investors' advisory board members bring benefits that make relinquishing some level of control a worthwhile investment. Founders should pay careful attention to who these advisory board members are.

A well-established advisory board can facilitate the company's strategic planning and supervision of the management by transferring some or all of the below powers from the shareholders' meeting to the advisory board:

- Appointment and dismissal of members of the management board, including granting power of sole representation (*Einzelvertretungsmacht*) and release from the restrictions regarding self-dealings and representation of multiple parties under sec. 181 German Civil Code;
- Making and receiving declarations in the company's name in order to conclude, amend and terminate a managing director's service agreement;
- Supervision of, advice to and support of the management board within the scope of the company's current operations and its strategic orientation;
- Making recommendations with regard to matters to be resolved in shareholders' meetings; and
- Most importantly, approving certain actions and measures of the management board.

In order to fulfil these obligations, the advisory board and its members are usually granted very broad information and inspection rights.

In German start-ups, advisory board members are usually only compensated for travel and out-of-pocket expenses, while a remuneration is (still) rather uncommon, with the exception of external (professional) advisory board members who (rarely) may receive a small cash remuneration or be allocated Stock Options (for details of such plans, see above under Chapter A.III.2.). Sometimes external advisory board members are invited to invest money in the company alongside the VCs.

1.3 Investor Majority and Investor Veto Rights

The investors will usually require that the company cannot engage in certain actions and that certain changes in the shareholder structure cannot be implemented without the consent of certain of the investors (irrespective of whether such decisions will be made at the level of the shareholders' meeting or at an advisory board level).

The rationale for these veto rights is that investors will often not have effective voting control but still want some say about important decisions and the ability to protect the value of their investment. In order not to give each of the investors a veto right, especially some early-stage investors who might only come to hold a tiny percentage in the company after a couple of financing rounds, consent rights are usually reserved for the largest investors only. Another more flexible and preferable way to achieve a reasonable level of control by the investors (taken as a group) is to make certain actions subject to the consent of the holders of a majority (or other specific percentage) of the preferred shares irrespective of the classes of preferred shares, *i.e.*, a so-called investor majority. It is generally recommended to have a dynamic definition of the investor majority that covers all classes of preferred shares rather than separate class-by-class votes or to give only a certain class of preferred shares a veto right. If a company does not have a dynamic definition, they might be faced with two or more veto constituents and the need to obtain two separate consent votes. This would arguably give the holders of preferred shares issued in the early rounds too much leverage.

We sometimes hear of founders who consider veto rights a sign of mistrust, but we would ask them to reconsider. Clearly defined veto rights help eliminate ambiguities in who gets to make bigger decisions of the company and help define the rules of engagements for a longer-term partnership. If a transaction makes sense, reasonable investors will vote in favor of such actions. Having to convince a sparring partner of your idea, to consider counterarguments and to get and

process feedback from professionals will always contribute to higher quality decision making. If the decisions are risky and require spending, founders should keep in mind that they are ultimately spending their investors' money, so it is legitimate for them to request to have a say in these decisions. Getting the investors onboard also increases the legitimacy of the decision and at the same time reduces the likelihood that the founders are held accountable for a (in the hindsight wrong) decision. But veto rights should be reserved for big-ticket items. They should not unduly stifle the company's agility in operational matters. Start-ups need to act quickly, and investors should only place bets on founders who they believe best understand the company's products, services and the market opportunities.

2. INFORMATION AND MONITORING RIGHTS

2.1 Information Rights

Most shareholders' agreements contain a section on the type of information the investor has access to and the time frame in which the company is obliged to provide it. Those information rights come on top of the mandatory pretty broad information rights that every shareholder in a GmbH or UG (*haftungsbeschränkt*) enjoys under sec. 51a German Limited Liability Companies Act (see Ninja Box in the adjacent column). Typical additional information rights can for example include the following:

- (Un-) audited financial statements including balance sheet data of the respective fiscal year;
- For more mature companies: unaudited monthly and/or quarterly financial statements of the company, including for example profit-and-loss statement, cash flow statement, a roll-over liquidity plan and management report covering all major events;
- Monthly investor briefings with certain KPIs;
- More and more often, regular ESG reporting and reports on the achievement on other corporate goals (see below under Chapter A.IV.3.1).

Obviously, the scope and level of detail of a regular reporting depends on the specific situation of the company and where it is on its growth trajectory. In early-stage investments, regular reporting obligations should be reasonably limited to ensure that the founders can focus on developing the company's products and services and get it off the ground.

DIFFERENCES FROM US AND UK INVESTMENTS: SHAREHOLDER INFORMATION RIGHTS

While in US & UK venture capital financings, certain information and inspection rights are often reserved for significant shareholders, *i.e.*, shareholders holding at least a certain stake in the company, under mandatory German law (sec. 51a German Limited Liability Companies Act), each shareholder in a GmbH, irrespective of the size of her stake, has a fairly comprehensive right to request information from the company and to inspect its records and books, subject only to certain confidentiality and non-compete restrictions.

This right to information includes all internal and external company affairs, such as any economic relationships with third parties, shareholder loans and managing directors' salary. In case the company has affiliated companies within the meaning of sects. 15 *et seq.* German Stock Corporation Act, the right to information also applies to such affiliated companies. Furthermore, the requesting shareholder does not need to demonstrate any legitimate interest for the inquiry, and the company may only rarely refuse to provide information and/or to grant access. As regulated by law, the managing directors may reject the shareholders' request if they are apprehensive that the shareholder will use the information for non-company or other inappropriate purposes and if, in addition, the shareholders pass a corresponding resolution of refusal. Only if shareholders request information whose disclosure would violate applicable laws or if they do not adhere to their loyalty duties towards the company and the co-shareholders, *e.g.*, by requesting information on trivial issues where responding would require unreasonable efforts or obstruct the management, the right to information can be denied without a shareholders' resolution.

In the event that the company is obliged to provide the requested information, the management board is – to the extent reasonable – obliged to do so, even if the necessary documents are not readily accessible. However, it may choose to deny the inspection of the company's books and records if the request can be fully satisfied by means of direct response.

Here, regular interaction with an active advisory board or certain experienced investors is generally a better use of the founders' resources rather than onerous formal reporting requirements. When the company grows, the reporting can become more institutionalized and professional. Quite a number of VCs have developed their own reporting software tools to limit the burden on their portfolio companies and streamline their own internal reporting processes.

2.2 Management Rights Letters for US Investors – ERISA Compliance

In particular US VCs will frequently also request a so-called management rights letter when investing in a German tech company. A management rights letter usually provides, *inter alia*, certain information and inspection rights should the US VC not have a seat on the company's board of directors.

The reason why a US VC may require such management rights letter is if a pension plan covered by the US Employee Retirement Income Security Act of 1974, or simply ERISA (an "ERISA Plan") invests in such US venture fund, then all of the fund's assets, including its investments in portfolio companies, are treated as assets of the ERISA Plan. As a result, the managing partner of the US venture fund is treated as an ERISA fiduciary and such fund must comply with the rules regarding prohibited transactions.

However, the US Department of Labor, which is charged with administering ERISA rules, has issued regulations that contain certain exemptions from the ERISA Plan asset rules. A US venture fund is not deemed to hold ERISA plan assets if it qualifies as a venture capital operating company (a "VCOC"). To qualify as a VCOC, the fund must have at least 50% of its assets invested in venture capital investments. An investment in a portfolio company qualifies as a "venture capital investment" if the fund obtains certain management rights with respect to the portfolio company, as reflected in typical management rights letters. In order to build a case for an exemption from the ERISA Plan asset rules, a US venture fund will generally ask each of its portfolio companies, including German companies, to sign a management rights letter in connection with its investment.

3. OTHER COVENANTS

The shareholders' agreement sometimes contains a number of additional protective covenants that address general or case-specific concerns of the incoming investor. Among the most common of these protective covenants are the following:

3.1 Environmental, Social and Governance Standards

Finally...

While Environmental, Social and Governance (ESG) standards (including diversity commitments) are becoming "table stakes" for public companies, regardless of a company's industry or market capitalization, these topics become more and more relevant for start-ups as well and founders are well-advised to have these topics high on their agendas.

Environmental criteria are used to measure how environmentally sound the production conditions are (*e.g.*, in terms of waste, pollution, greenhouse gas emissions, deforestation, and climate change) and the approach of the start-up to its footprint. Social criteria include relations between producers, suppliers, customers, and employees in terms of working conditions, health and safety, and equal opportunities. Governance criteria relate to leadership, management, and shareholder rights. Diversity commitments can not only include the start-up's leadership team and other employees but also its shareholders. Here, diversity usually means inclusiveness across gender, ethnicity, disabilities and any other protected characteristic.

While we will take a deep dive on the importance of ESG for start-ups and their investors in one of the next editions of OLNS, here are the top 5 reasons why founders should care:

- #1, #2 and #3: it is the right thing to do, seriously.
- #4: A company's sustainable orientation and credible commitment to a diverse and inclusive workforce enhances its corporate image, which in turn often leads to higher employee satisfaction, and attracts the interest of new young and innovative employees.
- #5: oh yes, and your investors will care. Investors, funds, and institutions have realized that for long-term profit, they need to focus on sustainably managed and thus viable businesses. Especially in the US but increasingly also in other countries, institutional investors consider, to varying degrees, ESG-related criteria when making investment decisions. Compared to other forms of financing, VC is particularly well suited for sustainable and business concepts and diverse teams. This is mainly because VC is uniquely compatible with the needs of sustainable projects. VC funds often have a long commitment period and thus meet the need of sustainable start-ups to secure investments for a longer ramp-up period, as long-term planning is a core element of these start-ups. Moreover, in addition to their financial support, VCs can be able to add value to sustainable start-ups by providing their technical knowledge, access to networks or management skills. In addition, there is a more profane explanation: VC and PE funds are under an increasing regulatory pressure; *e.g.*, on an EU level the Sustainable Finance Disclosure Regulation (SFDR) requires financial market participants and financial advisors to disclose certain ESG-related information on their website, in pre-contractual documents as well as in their periodic reporting.

ESG in Term Sheets and the Financing Documentation

Here are just a couple of examples how ESG and diversity topics might come up in term sheets and the financing round documentation[23]:

- Commitments to implement and continuously evaluate policies and best practices for the company's business activities with respect to environmental and social aspects.
- A typical more detailed covenant in the shareholders' agreement can then stipulate individual measures that the company undertakes to pursue to continuously reduce its carbon footprint, including third party assessments and benchmark testing on a regular basis, evaluation and implementation of carbon off-setting measures via certified partners combined with regular awareness and responsibility trainings of the own team and other stakeholders in the start-up's circle of influence.
- To ensure that the company complies with these obligations, investors may demand information rights and the implementation of adequate reporting structures. However, ESG clauses should always be tailored to the special situation of the company and set up in a way that the company's ESG actions can scale along its growth trajectory.

3.2 IP Provisions

Above (see Chapter A.I.), we talked about the importance of paying proper attention to IP-related questions and obtaining proper advice from a good law firm; investors sometimes require some additional protective covenants around IP issues that they might have identified in their due diligence or as a matter of precaution or principle.

Such provisions typically include provisions regarding the following:

- To the extent that such assignment is legally possible, each founder shall assign without any additional compensation to the company as a matter of precaution, to the broadest extent legally possible, any and all IP rights such founder may hold with respect to the business of the company. Any future findings or inventions by a founder capable of being protected and/or within the scope of business have to be assigned to the company as well.
- To the extent that such assignment is not legally possible, the respective founder shall at least grant to the company an exclusive and irrevocable license to use such (current or future) IP rights.
- The company and the founders shall use their best efforts to procure that (i) each person who is or will be involved in the creation or development of any IP rights for the company has signed a valid and enforceable agreement sufficient to irrevocably assign and transfer such IP rights to the company and (ii) that the know-how of the company is adequately protected.

It should be noted that such IP transfers may have tax implications. At times, investors expect the start-up company to be able to depreciate its IP from its agreed value (as agreed between the parties within the start-up valuation). Note that any such depreciation, if possible, may create personal tax issues for the founders, depending on the modalities in which they have held such IP. If the founders do not have the money to pay such tax, any such funds would have to come from the investor. In that situation, it is usually better if the IP is not depreciated from a large asset base rather than having an imminent liquidity drain in exchange for future benefits. So, investors and founders should review the tax consequences of the transfer of the IP and align their expectations accordingly to the outcome of such review.

3.3 Pooling

As we have seen, having numerous smaller investors on the cap table can create some problems. Shares in a GmbH or UG (*haftungsbeschränkt*) come with certain statutory rights irrespective of the size of the shareholding, including a right to information, a right to participate in shareholders' meeting and the right to challenge shareholders' resolutions. In a start-up, it is also sometimes necessary to obtain shareholders' approval for certain actions or measures or the issuance of new shares quickly. Here, it is a great advantage if the cap table is small or at least all shareholders are willing to waive formal requirements regarding the convocation, preparation and conduct of a shareholders' meeting and adopt

[23] You can find tons of materials and practical guidance at the Orrick ESG Resource Center: https://www.orrick.com/en/Practices/Environmental-Social-and-Corporate-Governance-ESG-Resource-Center.

decisions quickly. While there are certain options for the adoption of written shareholders' resolutions outside of shareholders' meetings that require the participation of only a qualified majority of votes, the most agile decision making process still requires the participation of all shareholders. Hence, the greater the cap table, the greater the risk that if only a single minority shareholder does not fall in line, a start-up will have to adhere to all formal requirements around convocation, preparation and holding of a shareholders' meeting, which will slow down the decision-making process.

To mitigate some of these issues, the shareholders' agreement will sometimes provide for a pooling covenant. This covenant will require the pool participants – often these are the small early-stage investors or employees and other early backers who have received shares in the company – to form a pool for a uniform and effective cast of votes in shareholders' resolutions of the company and to exercise their rights and fulfill their obligations under any investment agreement or shareholders' agreement pertaining to the company. The pool members will appoint a pool leader and give the pool leader usually a broad power-of-attorney to achieve the aforesaid goals. The pool leader can often decide in its discretion how to exercise the voting rights of the pool members or has to adhere to the outcome of an accelerated pre-vote amongst the pool members. The pool arrangement will usually contain a couple of further provisions to safeguard the interests of the pool members (*e.g.*, obligation of the pool leader to keep them reasonably informed or obtain internal consent on certain particularly relevant measures) and the pool leader (*e.g.*, limitation on its liability towards the pool members).

3.4 US Tax Covenants

If the company raises funds from US VCs (congratulations, that means that your company has made it at least through the initial stages), such investor will usually want to see some tax covenants in the shareholders' agreement or in a tax matters side letter. These provisions can be more or less detailed but will often address the following:

- The US VC will request some form of covenant that the company is properly treated as a corporation for US federal income tax purposes, and that the company will not take any action or make any election that will cause it to cease to be classified as a corporation for US federal income tax purposes. If there is US tax leakage for the US VC and/or its investors because of partnership/pass-through treatment of the company, US VC/investor may want to be reimbursed or even have a put option for its shares in that case.
- The US VC will also request some form of undertaking, that the company shall use commercially reasonable efforts to determine whether it or any of its subsidiaries is a passive foreign investment company for US federal income tax purposes (these are the so-called "PFIC" and unless you are a trained tax lawyer and love your profession – not so rare after all – the details of PFIC regulations can make you question the achievements of the Enlightenment). If the company determines that it or any of its subsidiaries fulfills the PFIC criteria for a taxable year, the company will need to provide additional information and cooperation to the US VC so that the US VC can comply with its tax law obligations at home.
- A similar covenant will oblige the start-up to determine whether it is a so-called "controlled foreign corporation" within the meaning of US tax laws and if so, the company will again need to provide the US VC with certain information and other assistance.
- Finally, there will often be a general cooperation undertaking from the company to allow the US VC to complete or make any tax filings or applications or to make any elections that the investor must make to obtain any available exemptions from or refunds of withholding or any similar taxes.
- It often makes sense to also agree on who shall pay for these services from the company. Often it can make sense to stipulate that any costs in excess of a low five digit EUR amount shall be borne by the investor request the respective assistance.

4. SHARE TRANSFERS AND EXIT

4.1 General Rules and Founders' Lock-Up

Transfer Restrictions and Permitted Transfers

Under the German Limited Liability Companies Act, shareholders in a GmbH can, in principle, freely transfer their shares to third parties, provided that the shareholders' list in the commercial register names them as holders and if the parties of the transfer adhere to the requirement of notarization of the share purchase (and transfer) agreement.

This obviously does not align with the interest of most shareholders in a GmbH, especially of founders and investors of a start-up following an investment. In fact, they have a legitimate interest in having a say in the decision of any change of shareholders, as all shareholders have inalienable statutory rights, such as the right to information and, even more importantly, voting rights enabling them to exert influence on the start-up (except in the rare cases where the start-up has also issued nonvoting shares).

For this reason, the articles of association and shareholders' agreements of basically all GmbHs in Germany provide for restrictions regarding the transferability of shares (in German: *Vinkulierung*). These provisions usually make any share transfer subject to the consent of the shareholders' meeting. Whether a share transfer requires only the simple majority of votes cast or in addition a preferred and/or common majority is a question of the respective bargaining powers.

However, the shareholders are often not free to decide on a share transfer approval request in their sole discretion. Rather, the shareholders' agreement will usually stipulate certain conditions under which the parties shall be obliged to vote their shares in favor of a transfer. Such cases generally include a group of permitted transfers (*e.g.*, transfers to an affiliated or in case of institutional VCs to other funds of the same fund family) as well as cases where the transferring shareholder has complied with the rules stipulated in the agreement regarding the right of first refusal, the drag-along and the tag-along right or similar provisions (for details, see under Chapter A.IV.4.2 and Chapter A.IV.4.3.

Founders' Lock-Up

It is crucial for the investors to keep the founders, whose commitment and know-how often are mission critical for the company's success, from exiting the start-up prematurely, in a worst case shortly after the investment. One way to ensure this is through a restriction on transfer of the founders' shares. The shareholders often agree on a founders' lock-up, further restricting the founders (or their founders HoldCo, as the case may be) from transferring their shares in the company for a certain period of time after the financing round (usually three to five years). Such period often, though not necessarily, corresponds to the vesting periods applicable for the founders (see under Chapter A.IV.5.). Exceptions from the founder lock-up restrictions usually require the consent of the advisory board and/or an investor majority.

In case the founders hold their shares indirectly (*i.e.*, via a founder HoldCo), it is important to extend the lock-up provisions to their shares in the founder HoldCo. If not, a founder could exit the company indirectly by transferring her shares in the founder HoldCo to third parties.

However, founders are usually granted the right (even during the founders' lock-up period) to request the consent to a transfer of her shares in the company or the shares in her founder HoldCo for estate planning or (by establishing a two-tier holding structure) tax optimization if certain criteria are met.

4.2 Right of First Refusal vs. Right of First Offer

Under a right of first refusal (*Vorerwerbsrecht*), if one shareholder has received an offer from a third-party and wishes to dispose of shares that are subject to a right of first refusal, such selling shareholder must first offer them upon the same terms and conditions to those other shareholders who have the benefit of the right of first refusal. There are usually certain exceptions to the right of first refusal, such as the right of individuals for estate planning or to an affiliate, etc. Although a right of first refusal is common in many German companies and an effective way to prevent an unwanted third-party from becoming a co-shareholder, it comes at a price. The requirement to go through a right of first refusal process may add several weeks to the sales process. This can negatively affect the third-party's willingness to engage in a due diligence exercise and make an offer for the sale shares in the first place unless the interested party can be reasonably sure that the right of first refusal will not be exercised.

An alternative to a right of first refusal is a right of first offer (*Andienungspflicht*). Here, the shareholder that intends to sell its shares to a third-party has only to offer them first to her co-shareholders without the need to already have obtained a third-party offer. The selling shareholder may accept or reject, in her sole discretion, any offer made by its co-shareholders. If the offers are rejected, the selling shareholder will be free within a certain period of time to sell and transfer the respective shares to any third-party, provided that the terms agreed with the acquiring third-party may not be more favorable to the acquiring party as those that were offered by any co-shareholder in her first offer; most notably, the acquiring third-party may not be offered a lower price for the shares than the price offered by the co-shareholders. With a right of first offer, the co-shareholders have the *de facto* option to set a floor for the share price, but can ultimately not prevent a third-party from acquiring the shares.

Right of first offers are also considered to be more "M&A friendly", as under a right of first refusal clause, an interested third-party may be reluctant to fully commit resources for due diligence and contract negotiations because the existing co-shareholders could still snap away the shares. Alternatively, the interested party may request a cost compensation undertaking before commencing due diligence and engaging outside advisors. However, in start-up land rights of first refusals are more common as the shareholders usually give more weight to preventing an unwanted party to become a shareholder as this might diminish the exit prospects for all parties and instill some discipline amongst all shareholders to work towards a more or less coordinated joint exit.

4.3 Drag-Along and Tag-Along

Drag-Along

A drag-along (sometimes called "bring-along") is a contractual arrangement that gives one or more shareholders, who hold either alone or together a certain percentage of the entire share capital of the company (usually more than 50%) and in many start-ups the majority of the preferred shares and, as the case may be, the majority of the common shares and who wish(es) to sell her (their) shares or a portion thereof to a third-party, the right to request all other shareholders to sell a *pro rata* portion of their shares to such third-party.

The drag-along is appealing to acquirers as it allows a 100% exit, leaving behind no minority shareholders. Buyers will often want to acquire 100% in a company in order to gain more flexibility and freedom to run the company as they see fit without having to pay attention to minority shareholders with certain unalienable minority protection rights. Please also keep in mind that German law does not provide for a squeeze-out option for a GmbH (for a German stock corporation, a squeeze-out option exists for a shareholder holding at least 95% of the stock corporation).

Under a simple drag-along provision, the dragged shareholders are obliged to accept the same terms and conditions (both legal and economic) that the dragging shareholder is willing to accept. However, as a matter of precaution, the shareholders might also contemplate certain conditions for the drag-along right when negotiating the shareholders' agreement, including the following:

- Dragged investors may argue that since they were not involved in the day-to-day operations of the company, they should only be obliged to give representations, warranties, indemnities or other claims with respect to the title in, and third-party rights regarding their shares and their respective capacity to enter into, the respective transaction or make all operational representations and warranties subject only to their positive knowledge or if the liability is limited to a certain portion of the purchase price paid into an escrow account.
- Investors will usually insist that they cannot be requested to accept a non-compete and non-solicitation undertaking. Founders should also consider carefully whether and under what circumstances they shall be required to accept such restrictive covenants. Founders usually hold common shares and will thus only benefit at the lowest level of the waterfall when it comes to the distribution of the exit proceeds. If they will receive only a relatively small price for the shares and will still need to continue working in the same industry for a living, it may be appropriate to carve them out from general non-compete undertakings.
- Usually, the drag-along right will require that the underlying exit must provide for a consideration to be paid all in cash or in publicly traded securities.

Drag-along rights are one of the topics where the interests of investors may differ. Investors who come in in the various financing rounds will usually invest at different price points, *i.e.*, valuations of the start-up. Hence, even if their classes of preferred shares would otherwise have a *pari passu* liquidation preference, their views on an exit might differ. For early-stage investors (they will often still hold a substantial portion of the preferred shares) a certain exit opportunity might look appealing. Later stage investors have usually still more time for an exit and will want to wait until the company's valuation has bumped up so that they make a certain minimum return (for many 3x is kind of an unspoken threshold). Thus, especially after a significant uptick of the company's valuation from the last financing round, the new investors of the current financing round will often request a veto on being dragged into an exit for a certain period of time (*e.g.* 12 to 18 months) unless the exit occurs at valuation that is a certain multiple of the current financing round's valuation.

Tag-Along

A tag-along right (sometimes also referred to as a "co-sale right") refers to a mechanism that ensures that if one shareholder or a group of shareholders has an opportunity to sell shares to a third-party, the other shareholders are also given that opportunity on a *pro rata* basis. The other shareholders can join the deal on the same terms and conditions that apply to the selling shareholder(s). Sometimes tag-along rights are designed in a way that they apply only if other shareholders sell a majority of the company's nominal capital, particularly in cases where the selling shareholder(s) are only entitled to a drag-along right if they sell a majority of the nominal capital of the company. The rationale behind this is that the tag-along is the flipside of the drag-along and is intended to protect the minority shareholders from being left behind if the majority shareholder(s) do not exercise the drag-along right. Sometimes, the tag-along right is structure as a competitor deterrent, *i.e.*, it allows for the other shareholders to tag not only a portion of their shares but all of them if the selling shareholder intends to sell her shares to a competitor of the start-up. There might also be a full tag-along right for all shares (and not just a *pro rata* tag-along right) in case of a change-of-control transaction, *i.e.*, where the acquirer becomes the majority shareholder of the start-up.

Whether or not the holders of common shares shall have a tag-along right for every transfer of preferred shares or only in case of a change-of-control or exit transaction and/or whether their tag-along right shall only apply to their vested portion of the common shares is a matter of negotiation (thought at least the latter is a rather customary provision).

4.4 Exit and the Exit Process

All good things must come to an end. Founders and their investors may collaborate for a meaningful period of time, but eventually they will part ways. Institutional VCs will generally seek to exit their investments within a period of four to six years after the initial investment.

We have already come across a number of exit-related provisions (usually included in the shareholders' agreement), including the drag-along right that is designed to allow for a 100% exit irrespective of dissenting minority shareholders, the tag-along right to protect the minority shareholders from being left behind, and the liquidation preference that sets forth how exit proceeds shall be divided among the respective shareholders.

In addition, the shareholders' agreement usually contains a number of provisions about what is considered an exit event and how the exit process will work. At least in later rounds or once US investors come on board, there will often also be IPO-related provisions dealing with an IPO as a special form of an exit (see Chapter A.IV.4.5).

Here are the transactions that usually qualify as an exit (other than an IPO):

- Transfer of more than 50% of the outstanding share capital of the start-up to a third party (may or may not include a shareholder), this is often called a "share deal exit".
- Transfer of the Company's assets that represent more than 50% of the start-up's total assets (based on their fair market value and not what is shown on the company's balance sheet under GAAP).
- Certain other forms of restructurings (*e.g.*, mergers) that result in the existing shareholders ultimately holding (directly or indirectly) less than 50% of the share capital or voting rights in the start-up.

General provisions around the exit process often deal with who can initiate the exit process, how outside counsel and M&A advisors are engaged to scout exit opportunities and who pays for their costs and expenses. To streamline the exit process, it is also often advisable to have some rules about which of the shareholders should be authorized to conduct the negotiations, who is responsible for allowing and supporting a customary due diligence and who will provide support for road shows and investor discussions and other related activities.

4.5 IPO-Related Provisions

In the US, an initial public offering (IPO) is often seen as a significant step in the maturation of a business from a small start-up stage to a successful operating company. In the now-infamous dot-com days, entrepreneurs quickly gained access to the public markets. In Germany, this was true to a lesser extent for the technology sector around the turn of the millennium. Today, most start-ups will be in business for a number of years and complete several financing rounds before they can prepare to go public. However, despite the recent boom in start-up IPOs, in reality it is still a small fraction of start-ups that go public.

So you might wonder why bother including IPO-related provisions in the shareholders' agreement in the first place. We agree in principle, but there are cases where it makes sense to set forth some basic rules of engagement early if there is a serious prospect that the company will one day go public, be that in Germany or on international stock exchanges such as NASDAQ. Further, if the company seeks funds from major British or American investors, they will be used to having some language around IPO in their financing agreements. Typical provisions around an IPO and the underlying process that might be found in (later-stage) shareholders' agreements include the following:

- The company will pursue a listing at a German and/or other reputable international stock exchange upon the request of certain investors and/or the advisory board.
- If a listing at a German stock exchange is pursued, the company shall be transformed from a GmbH into an AG, *i.e.,* a German stock corporation, or a SE, *i.e.,* a European stock corporation or for those folks who were always wondering when Latin language skills would be useful – *Societas Europaea*. AG and SE are legal forms that are suitable to go public. The shareholders are obliged to support this transformation, which should include the waiver of any statutory exit rights (*Abfindungsansprüche*). The shareholders' agreement should then also require the company to change the structure of the advisory board to a supervisory board as a supervisory board is a mandatory corporate body for a stock corporation.
- As an alternative to a transformation of the company itself and its subsequent listing, the shareholders' agreement may also provide for the option of a flip into a US legal form or another European legal form (*e.g.*, Luxembourg stock corporation (*Société Anonyme*). A flip refers to the "transfer" of a German start-up to a US or other foreign legal structure. There are various motivations for doing a flip in preparation for an IPO the most common reasons are to have a legal form accommodating investors' expectations and to put in place a US or US-style governance structure. In this process, the shareholders "swap" or "flip" their shares in the business-carrying German company for shares in a US or other foreign company. As a result, between the founders and investors of the German company, a new US or other foreign parent company is established which can then be floated. As a flip may result in a taxable event for the shareholders, the shareholders' agreement might make the obligation to support a flip subject to the condition that the existing shareholders shall not suffer any unreasonable tax disadvantages or other material detriments[24].
- All shareholders are usually subject to rather broad cooperation obligations. This may include the obligation that all shareholders will fully cooperate with each other, provide all requested consents and take all requested measures to execute the IPO. Other steps to be taken may include the conversion of preferred shares to common shares, execution of customary lock-up undertakings as recommended by the advising investment banks, the amendment of the company's articles of association as appropriate for a listed company, assisting with the preparation of the prospectus or any other offer document to be published in connection with the IPO and entering into an underwriting agreement on market-standard terms.
- Finally, the shareholders' agreement may also include some special provisions for listings on a US stock exchange that larger US venture capital investors may require. This may include the obligation to enter into a registration rights agreement in favor of the holders of preferred shares, which would obligate the company to file a registration statement covering the sale of registrable securities and "piggyback" registration rights (see below).

24 For details about flip structures and their (tax) consequences see our Guide OLNS#7 – Flip it Right, which can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/olns-7-flip-it-right.pdf.

DIFFERENCES FROM US INVESTMENTS: REGISTRATION RIGHTS

Under US securities law, shares in a company can only be offered in an IPO (with certain exceptions) if they have first been registered with the Securities and Exchange Commission (SEC). The registration process involves the company whose shares are to be offered, providing significant amounts of information about its operations and financial condition, which can be time-consuming and costly. As a company registering shares to be traded in the US is not required to register all of its outstanding shares, investors in the US or in German technology companies which may, following a flip, consider pursuing a listing in the US will require the company to enter into a registration rights agreement. Under such an agreement, the investor can demand the registration of its shares under certain circumstances and to have its shares registered along with any other shares of the company being registered (piggy-back rights).

These registration rights are a US securities law concept that is alien to German law. Under German law, if a company's shares are floated on a German stock exchange, generally all its shares become tradable (subject to contractual lock-ups).

4.6 De-SPAC Related Provisions

In recent years, the merger with so-called Special Purpose Acquisition Companies (SPACs) has become popular again among fast growing start-ups. SPACs are stock-listed companies with the sole purpose to collect money from investors and then merge with a start-up (the merger with the start-up is typically called De-SPAC). That's why SPACs are also called blank-check companies. Economically, a De-SPAC transaction is an exit opportunity similar to an IPO for the existing investors combined with a fundraising. De-SPAC transactions are often done in the pre-revenue phase and can be an attractive source of capital for start-ups with a high cash burn rate.

Similar to an IPO-scenario, you might wonder why bother including De-SPAC-related provisions in the shareholders' agreement in the first place. We agree in principle, but there are cases where it makes sense to set forth some basic rules of engagement early if there is a serious prospect that the company may one day consider doing a De-SPAC transaction. Typical provisions to address a De-SPAC transaction in shareholders' agreements should include the following:

- The shareholders' agreement should allow for a majority decision (in whatsoever form) to pursue with a De-SPAC transaction. Older shareholders' agreements are often silent on approval requirements for pursuing with a De-SPAC transaction.
- The shareholders' agreement should contain broad cooperation obligations for the investors similar to such in the context of an IPO (including, without being limited thereto, the obligation to accept lock up provisions).
- Flexibility on structuring: The shareholders' agreement should provide flexibility to restructure the legal form/entity type of the start-up to make it fit for a De-SPAC transaction. Typically, a German start-up is organized as a GmbH which is not capable of being listed at a stock exchange. The legal form of the start-up can be changed into a German stock corporation or a *Societas Europaea* (SE) but there can also be other structures (*e.g.* a new non-German holding company) to facilitate a De-SPAC transaction. Putting aside governance aspects, the structure is typically driven by tax considerations and it should be safeguarded that none of the investors individually can block any such structure.
- To increase deal certainty, it's also recommended to make the drag along provisions apply to De-SPAC restructuring. In a De-SPAC-transaction it is all about deal certainty and speed and the drag along provision help to avoid that individual shareholders *de facto* block the transaction.
- Finally, it should be considered whether the closing of a De-SPAC transaction shall qualify as an exit event for purposes of the start-up's VSOP or ESOP. There is no one size fits all answer to this as a start-up, at the time of the De-SPAC-transaction often is pre-revenue and still in the development phase of its product. This votes in favor of not qualifying the closing of a De-SPAC-transaction as an exit event for purposes of the start-up's VSOP or ESOP. On the other side US market practice where options granted can typically be exercised once vested should be considered.

It is a platitude, but founders are central to the success of the start-up. It's not easy to predict which founders will succeed. In early-stage companies, there is not a lot of information about how a company's products and services will perform in the market over time. In essence, early-stage venture capital investments are educated bets on the founder team (coupled with – depending on the market cycle – a more or less strong element of herd behavior).

Having decided to put money behind a founder team they believe in, investors are keen to ensure that the founders remain committed to the company and stay on board to deliver on their business promises. They will routinely negotiate vesting provisions and strict rules around founder leaver events (at least in the first financing rounds). On the other hand, the current market environment does not always allow for requesting the vesting concept to be applied to all shares of the founders (in particular in later-stage financings or in cases where founders already have considerable industry experience). Another aspect is that it can be in the founders' own best interest to incentivize their fellow founder team members to stay on board for a certain period of time.

A tested tool to ensure aligned incentives among founders and their investors are call-options on the founders' shares if they leave the company within a certain period of time. If a founder leaves the company prematurely, under a vesting scheme, she will lose parts or all of her shares in the company. The reasons for her departure can be reflected in the number of shares subject to the call-option and/or the purchase price to be paid to her for her shares. Drawn with a broad brush, good leavers usually get the highest compensation (usually the fair market value of the called shares), while bad leavers often get the lowest compensation permissible under applicable law. Recently, we also see more balanced approaches in the German market that do not only follow a black (bad leaver) and white (good leaver) approach but that also foresee grey leaver provisions.

Call-options in case of a leaver event are usually coupled with a vesting schedule in order to incentivize the founders not to leave the company in the short term. From an economic perspective, a vesting schedule results in the founder – despite being the legal owner of her shares – "acquiring" the economic value of her shares only over a certain period of time subject to the nonoccurrence of a leaver event.

5. FOUNDER VESTING AND LEAVER EVENTS

5.1 Call-Options and the Vesting Schedule

Call-Option

Vesting clauses usually provide for a call-option to be granted by the founders to the (lead) investors, the company or a third-party nominated by the (lead) investors or the company (*e.g.*, a new manager) to acquire all of their unvested shares in case of a good leaver event (*i.e.*, the leaving shareholder can keep the vested shares). In addition, it will often be appropriate to also make the vested shares subject to the call-option in bad leaver cases, as the investors do not want to have a bad leaver as a remaining shareholder. In such bad leaver cases, the difference between vested and unvested shares will then only be relevant for the determination of the compensation.

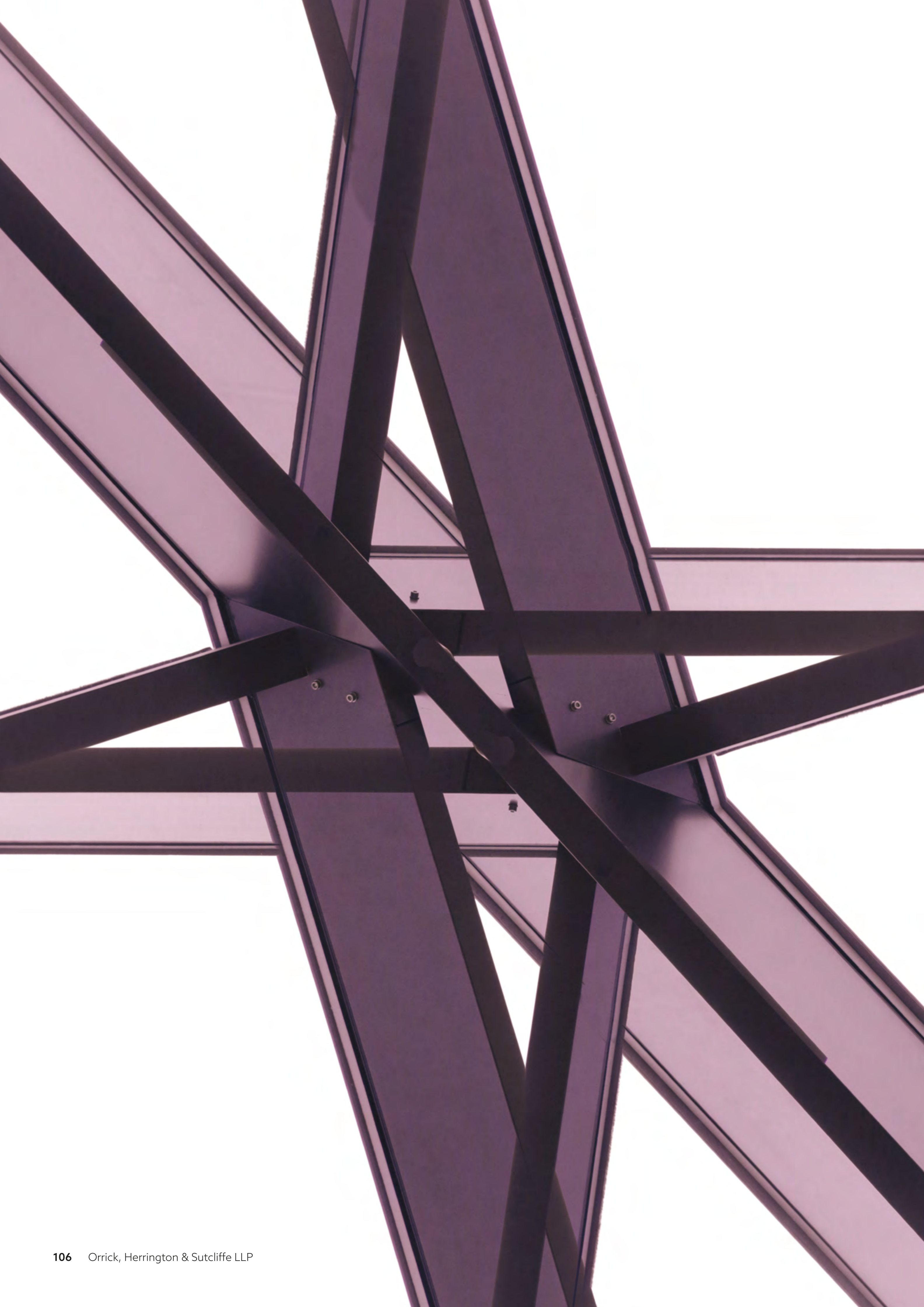
The call-option can be structured as a contractual obligation in the shareholders' agreement to offer the respective shares upon a leaver event. Another alternative is to structure it as an irrevocable offer by the shareholder, which then only needs to be accepted by the respective beneficiary in the required form (a so-called self-executing call-option). This will give the investors a higher level of comfort, as the shares are automatically transferred upon the acceptance. In the first case, the investors (or the company) would have to enforce the obligation to transfer the shares, whereas in the latter case, the respective founder would have to claim a retransfer of shares in case of a dispute as to whether a leaver event has occurred. To further safeguard the investors' interests, a corresponding redemption right can be set forth in the articles of association.

Self-executing call-options require careful drafting so that the acting notary is comfortable to actually file an updated shareholders' list with the commercial register of the company after the respective beneficiary has triggered the call-option. In particular, the call-option clause should specify which shares exactly are subject to the share transfer and should state that shares with the lowest consecutive numbers (*niedrigste laufende Nummer*) in the shareholders' list shall vest first. Special attention must also be paid to the proper drafting of all clauses around the calculation of the call-option purchase price and its payment, as the acting notary will often need to convince herself that payment of the "right" call-option price has occurred as this is usually a condition precedent for the transfer of the called shares.

Vesting Schedule and Cliff

The founders' unvested shares vest over a certain period of time until all founders' shares have become vested shares. In early-stage investments, in order to avoid windfall profits, no shares shall be deemed vested if a leaver event occurs within a certain period (usually one year) after the beginning of the vesting period (so-called cliff).

For early-stage financings, a three- to four-year monthly (sometimes quarterly) vesting schedule with a one-year cliff and a (fully or partially) accelerated vesting upon the occurrence of an exit event are standard for founders. However, the details are subject to negotiation, and it is not uncommon to have different vesting schedules for individual founders. For example, in order to compensate a founder for existing time served for the company, a certain percentage of her shares could be treated as so-called sweat shares and thus be considered vested as of the closing of the financing round. In follow-on financing rounds, investors may ask for a part or all of the vested shares to become unvested shares again and for the vesting schedule to be adjusted accordingly to ensure continued commitment by the founders. However, in later-stage financings, founders will often be in a position to assert that the vesting concept is not applied to their existing shares which have already vested.



5.2 Leaver Events and Compensation

Leaver events are regularly linked to the termination of a founder's managing director service agreement, consultancy agreement or employment contract (as the case may be) or revocation of the founder's appointment as managing director of the company.

Some typical examples for good leaver events are:

- The contract or appointment as managing director is terminated/revoked by the company other than for good cause;
- The founder terminates her contract or resigns from her appointment as managing director for good cause;
- Death of the founder; or
- Permanent disability of the founder.

Bad leaver events are usually given if:

- The contract or appointment as managing director is terminated/revoked by the company/shareholders' meeting for good cause, in particular, if the founder is responsible for such good cause;
- The founder terminates her contract or resigns from her appointment as managing director without good cause;
- The founder has become insolvent or unable to pay her debts as they fall due or has been adjudicated bankrupt or entered into any reorganization or other special arrangement with her creditors generally; or
- A third-party has taken steps to enforce security rights or claims to the shareholdings held by the founder.

Depending on the particularities of the case at hand, further specific good/bad leaver events may be appropriate. In addition, the shareholders' meeting or the advisory board can be granted the right to determine whether a leaver is to be treated as a good or bad leaver.

Although this can make the whole vesting question even more complex, sometimes it makes sense to also provide for a so-called grey leaver clause for events that straddle the good leaver/bad leaver divide. The typical case for a grey leaver is that the founder terminates her contract with the company or resigns from her appointment as a managing director after a certain minimum period (*e.g.*, two years) without good cause, but hasn't done anything that would justify treating her as a "typical" bad leaver. The grey leaver provision may provide that the leaver can keep a certain portion of her vested shares (instead of all, as in the case of a good leaver) rather than lose all of them (in case of a bad leaver).

This differentiation is relevant to the compensation to be paid to the leaver. A good leaver will usually get the fair market value for her transferred unvested shares. As it may be difficult to determine the fair market value, particularly in early-stage companies that are not yet in the profit zone, the compensation can also be linked to the share price in the last financing round prior to the leaver event.

A bad leaver will usually only receive the higher of the book value and the nominal value of the transferred unvested shares and, as the case may be, also for the vested shares (although sometimes bad leavers are also paid the fair market value for their vested shares minus a discount of *e.g.*, 50%). In the absence of a comprehensive body of case law on which compensation is appropriate in case of founder leaver events and in order to avoid invalid leaver provisions, it is recommended to provide a fallback clause, where compensation amounts will be paid at the lowest value permissible by law, in case the agreed-upon compensation would otherwise be regarded inappropriate.

V. How Lawyers Fill the Remaining Pages

As *Albert Einstein* said: "The most powerful force in the universe is the lawyers' imagination in coming up with even more provisions." Of course he didn't say that, although he left us quotes and sound bites for almost everything and attributing this quote to him is gangster. But anyway, in this Guide we can only present a selection of certain topics that we consider to be of particular importance. In this Chapter, we picked out a few more provisions that come up in many venture capital financings in Germany.

1. DISPUTE SETTLEMENT

1.1 Resolution of Specific Business Disputes by Expert Determination

According to our experience, it is rare that disputes in start-up land find their way to the courts or to arbitration proceedings. We have seen a few cases about the calculation of the reduced valuation in case of a breach of a representation or warranty or over the computation of the compensation amount following a redemption of shares. Other cases related to supposedly bad leaver events for founders and their consequences.

For factual questions, like the aforesaid disputes about the "right" amount, the parties should consider having an independent expert make the determination, for instance, an expert nominated by the German Institute of Auditors – *Institut der Wirtschaftsprüfer in Deutschland e.V. – IDW*. It is our experience that expert determination prevents many disputes from escalating into actual litigation or arbitration because once the factual issues have been set aside, most parties can reach a joint understanding.

Under German substantive law, expert determination will be authoritative for any later litigation (or arbitration) between the parties to the extent to which this litigation (or arbitration) relates to the question of fact that has already been determined. This is because the expert determination qualifies as a specification of performance by a third-party (sec. 317 German Civil Code). While the determination on the facts will be binding upon the parties, the expert does not decide on legal claims so that the expert's decision will not contain a specific order to any of the parties (*e.g.*, for payment), and it will also not be enforceable. An expert determination can only be annulled by a court (or arbitral tribunal) if it is found to be evidently inequitable or evidently wrong (analogy to sec. 319 German Civil Code). This is a relatively high hurdle, but it may be overcome.

From a practical perspective, the scope of the determination and the expert's powers and duties should be defined as precisely as possible. In the investment and/or shareholders' agreements, it should state that the expert is empowered to decide on legal questions that underlie the factual question at hand (*e.g.*, the interpretation and application of German generally accepted accounting principles in order to determine certain items of the financial statements). The expert should also be required to hear the parties, to grant them an opportunity to present their views in writing and to give a reasoned decision. If the parties agree on arbitration proceedings, they should also clarify that the arbitral tribunal shall be competent to decide upon a potential annulment of the expert determination.

1.2 General Dispute Settlement and Arbitration Clause

The financing round documentation should also specify how and where potential disputes should be resolved. There are a number of dispute resolution mechanisms. The default option (if nothing else is agreed) is litigation before the ordinary state courts, if and to the extent to which they are competent (usually at the defendant's seat). However, the parties can choose from a variety of alternatives, ranging from mediation (where a mediator assists, on a nonbinding basis, in the finding of a settlement) to arbitration (where an arbitral tribunal bindingly decides in lieu of the ordinary state courts). All these mechanisms have preferences and drawbacks, which the parties should consider.

Though the following observation mainly stem from the realm of joint venture and M&A disputes, we want to share them here nevertheless as every now and then similar questions arise in the aftermath of a venture capital financing.

Arbitration can offer a number of advantages over state court litigation, particularly with respect to investment and shareholder disputes:

- Expertise. Since the parties can select the (independent) arbitrators individually, they can ensure an extraordinary degree of expertise that the state courts will hardly be able to match. This advantage should not be underestimated.
- Speed. Arbitration proceedings can be conducted faster and more focused. Arbitrators can (and should) be chosen according to their availability. Many arbitral institutions define deadlines by when the proceedings must be completed. Arbitral awards (the equivalent to state court judgments) can only be annulled on very limited grounds; there are no appeals on a point of law.
- Language. Before state courts, the parties must litigate in the local language(s). In arbitration, the parties can select the language of the proceedings and provide for the taking of evidence in various languages.
- Costs. Arbitration proceedings are not necessarily less expensive than state court litigations; in fact, in the case of small claims, they may be more costly. Yet since arbitrations usually comprise only one instance, they may often end up more favorable in the long run compared to state court litigations that may be escalated through appeals.
- Confidentiality. Arbitrations are not open to the public, and often the parties agree on the confidentiality of the proceedings in their entirety. The arbitrators are also bound by confidentiality obligations.
- Enforceability. State court judgments can only be enforced if the country where enforcement is sought acknowledges and recognizes judgments from the originating country. For instance, Germany will not enforce judgments from India or Liechtenstein (and *vice versa*), and Austria does not enforce any US judgment in a commercial law matter. Arbitral awards, on the other hand, are almost uniformly enforceable worldwide thanks to the widespread accession to the New York Convention in 1957 on the Enforcement of Foreign Arbitral Awards.

Among the issues to be considered when drafting an arbitration clause are the applicable rules of arbitration (in Germany usually the DIS rules, sometimes in international technology M&A deals, also the ICC rules), the number of arbitrators, the place of the arbitration and the ability to provide evidence in languages other than German.

2. MATRIMONIAL REGIME AND PRENUPTIAL AGREEMENTS

In Germany, there are different matrimonial property regimes, which also apply to civil partnerships (*eingetragene Lebenspartnerschaften*) concluded before October 2017. Most spouses live under the regime of community of accrued gains (*gesetzlicher Güterstand der Zugewinngemeinschaft*) which applies by default unless agreed otherwise by prenuptial agreement (*Ehevertrag*). Under the regime of community of accrued gains, each spouse generally manages her own property independently. However, founders and investors should be well aware of the following applicable restrictions and particularities of such regime:

- The married shareholder's authority to dispose of her shares in the company may require the respective spouse's consent if the respective shares represent the shareholder's entire property or her *de facto* entire property, which might, according to applicable case law, already be the case if they represent about at least 80–90% of the property (see sec. 1365 German Civil Code).

  If at the point of a contemplated transfer of the shares in the company, these shares represent the shareholder's entire property and the spouse does not grant her consent, such transfer would be void even if the shareholder would receive the shares' fair market value or more. This transfer restriction can be a real headache for founders and investors as it can render an exercised call-option on the founder's shares in the case of a founder's leaver event becoming useless, and affect an exit transaction if the founder or an investor being a natural person cannot transfer her shares, whether voluntarily or when being dragged into the exit.

- The respective shareholder's shares may also become the subject of accrued gains equalization claims (*Zugewinnausgleichsansprüche*), especially in case of a divorce. Such claims do not force the shareholder to transfer her shares to the spouse, since the spouse is only entitled to a compensation for an increase in value. However, such outcome is not desirable, as it may force the shareholder to liquidate her shareholding in order to fulfill such compensation claims. Furthermore, the calculation of the amount of the respective claim may require an inconvenient valuation of the company.

It should be noted that the transfer issue is less relevant in cases where the founders hold their shares in the start-up not directly but through a founder holding entity (see above under Chapter A.II.1.). Here the aforesaid transfer restrictions do not apply as in such a case the shareholder (*i.e.*, the founder holding entity) would not be a married individual.

> If you are not yet married, please read this. And if you are already married, then first of all congratulations but please read this nevertheless.

Against this background, founders should be aware that many investors will request to include covenants in the shareholders' agreement that any individual holding shares in the start-up needs to make sure that such shares can be freely transferred. For example, the founder could agree with her spouse to agree to the separate estate regime (*Gütertrennung*) or, in case they choose the joint estate regime (*Gütergemeinschaft*), to declare the shares as separate property (*Vorbehaltsgut*) and to register for the property registry (*Güterrechtsregister*). In most cases, the founder will enter into a matrimonial regime with her spouse and stipulate therein that the restrictions set forth in sec. 1365 German Civil Code shall not apply to them.

Additionally, it is advisable to include a provision in the company's articles of association that allows the company to redeem shares in case of noncompliance, or, at the very least, if the shares should become subject to an accrued gains equalization claims procedure. It is often more convenient to redeem the shares instead of (judicially) enforcing the obligation to transfer the shares.

3. NON-COMPETE AND NON-SOLICITATION

Non-compete Undertakings

The investors will want to make sure that the founders are fully focused on the company and its development, and not engaging in any potentially distracting sideline activities, in particular, those that might compete with the company. Non-compete provisions for the founders are thus a standard part of many investment and shareholders' agreements. Whether or not investors agree to similar restrictions is a matter of negotiation, although larger investors will usually reject any non-compete, insisting on their fund's freedom to invest as it sees fit and that they will keep enough white space between their investments.

For a founder, the non-compete covenant usually applies for the period during which (i) the founder serves as director, officer, employee or freelancer of the company or (ii) she (or her respective founder HoldCo) holds shares in the company and for a subsequent period of 12 to 24 months thereafter. While this reflects the standard language that can be found in many shareholders' agreements, founders should think about this. Sometimes, founders will (more or less on a voluntary basis) no longer be involved and hold a relatively small stake in the company. Although they might have received little liquidity from their shareholdings so far, they could then be still banned (depending on how broad the non-compete is phrased) from the sector of the job market they know best. To avoid undue hardship, it can thus make sense to include some kind of "sun-down" provision for the non-compete covenant, *e.g.*, that the non-compete covenant shall lapse early once the respective founder (i) for a period of [■] months, has neither been employed or otherwise engaged by the start-up, nor has been a member of its advisory board and at the end of such period holds, directly or indirectly, less than a certain percentage of the company's outstanding share capital.

The non-compete restrictions usually ban the respective party from the following activities: (i) soliciting business from or canvassing any customers or prospective customers of the company in respect of the company's activities within the scope of its business; (ii) accepting orders from, acting for or having any business dealings with, any customers or any prospective customers in respect of the aforementioned restricted services; and (iii) holding any shares or interests in any entity that is involved in dealing with such restricted services except for equity interests that are held as a financial investment only, *i.e.*, do not give the right, directly or indirectly, to control or exert material influence over the business or management of the respective entity. In order to be valid, the non-compete must be, *inter alia*, geographically limited to geography in which the company has business dealings or concrete market-entry plans.

To give them teeth, breaches of a non-compete are often also sanctioned by a contractual penalty the amount of which tends to rise with the company's valuation, often starting with EUR 25,000 per breach of the non-compete, provided that often every two or four weeks of a continuous breach will be considered as a new breach, *i.e.*, triggering the contractual penalty again.

Non-solicitation Undertakings

Non-solicitation undertakings are usually given by all shareholders. Under such an undertaking, the shareholders agree to not solicit and/or entice employees away from the company unless the employee initiated unsolicited hiring discussions with the shareholder or responds to a general public solicitation by the shareholder that is not purposefully directed to the respective employee (although large corporate investors with huge international operations will often request an exemption claiming that given their widespread operations an enforcement of a non-solicitation undertaking would not be practicable for them).

4. THE "BOILERPLATES"

When negotiating investment and shareholders' agreements for venture capital financings, one often concentrates on the clauses around economic ownership and control over the company and pays less attention to those provisions usually buried at the end of a 50+ page document – the so-called boilerplate clauses.

In this last Chapter, we want to give a brief overview of some common boilerplates and explain the underlying purpose of certain boilerplate clauses and what investors and founders should look out for.

Boilerplate Clause	Comments
COSTS	
It is standard that any notary fees and other public charges and costs in connection with the primary investment are borne by the company. While, as a principle, it's reasonable that each party shall bear its own charges, costs and fees and those of its advisors, the investment agreement often provide that reasonable expenses outside counsel incurred by the (lead) investor in connection with the preparation, execution and implementation of the financing round shall be borne by the company. If the company should reimburse the (lead) investor for the costs of outside counsel, that undertaking should be capped at a reasonable amount. Cases may differ but up until Series A financings, cost reimbursements for the lead investor in a "standard" financing usually do not exceed EUR 50,000 to EUR 60,000 (net).	Depending on the size of the financing and other provisions stipulated in the investment and shareholders' agreements, the notarization costs can be quite substantial. Such other public charges and costs include the (usually rather small) fees for making filings with the commercial register and (in rare cases) the (more substantial) fees for merger clearances. If the financing round also includes secondary share sales, the associated notarization fees should be borne by the sellers (very rare) or the purchaser (standard case) while any allocation of these costs to the company should be first checked with a tax advisor. The German Act on Costs of Courts and Notaries (GNotKG) provides for the rules of calculation of the fees, and although it is binding for all notaries in Germany, it also grants the notary limited discretionary powers for some matters. The act is rather complex, and some seemingly minor factors can increase the costs of notarization significantly. While most transaction documentation these days is in English (which increases notarization fees), other cost traps can often be avoided (*e.g.*, by properly drafting the clauses on governing law (see below). For example, costs can increase if the parties send a draft of a document to the notary before the actual notarization. If the notary makes any changes (including wording/spelling mistakes) in the course of this, she is allowed to charge a partial or even a full "drafting fee". While surprises with the better known notaries that frequently notarize venture deals are relatively rare, we nevertheless advise our clients to check with the notary in advance and to make clear that any provision of documents ahead of the notarization of the (main or reference) deed is for information purposes only. If the company should reimburse the (lead) investor for the costs of outside counsel, that undertaking should be capped at a reasonable amount. Cases may differ but up until Series A financings, cost reimbursements for the lead investor in a "standard" financing usually do not exceed EUR 50,000 to EUR 60,000 (net).

Boilerplate Clause	Comments
CONFIDENTIALITY AND PUBLIC DISCLOSURES	
These provisions set forth the rules about any press release or similar public announcement about the investors' investment in the company. More importantly, they provide for strict undertakings of each party to keep confidential and not to disclose to any third-party any information regarding the other parties, in particular the company and its business operations. These clauses usually contain definitions of what constitutes "confidential information" and certain exemptions when it is okay to disclose confidential information. These permitted disclosures should at least include disclosures to the respective party's advisors and direct or indirect shareholders or financial sponsors (in all cases subject to the receiving party being subject to a similar level of confidentiality obligations) or where a disclosure is required under applicable law or court rulings.	This is an important standard clause. In particular, the confidentiality undertaking should be drafted in an unambiguous way. It is also recommended that you clearly state that the confidentiality undertaking shall continue to apply (at least for a certain period of time of around two to three years) after a party ceases to be a party to the investment and shareholders' agreements. As we have seen, the shareholders' agreements usually contains provisions setting forth the conditions under which shareholders are entitled to sell their shares to a third-party (including dragging all other shareholders in certain cases). Such third-party will usually insist on a due diligence of the company. It may thus make sense to also include in the shareholders' agreement provisions under which circumstances a shareholder may receive and disclose the information required to allow the third-party to conduct its due diligence.
NOTICES	
This clause sets forth some rules for the communication among the parties. Such provisions usually include the language for any communication and the means of communication.	This clause sets forth some rules for the communication among the parties. Such provisions usually include the language for any communication and the means of communication. Here, it may make sense to require written communication by means of a registered mail or the like only for the most material communication, such as the termination of the investment and shareholders' agreements, but otherwise on the so-called text form pursuant to sec. 126b German Civil Code, which includes for example email, pdf and fax[25] for the day-to-day communication.
ENTIRE AGREEMENT	
With this clause, the parties confirm to each other that the investment and shareholders' agreement (including all annexes hereto) contains the entire agreement between the parties with respect to the subject matter of this agreement and supersedes all prior agreements and understandings with respect thereto, provided, however, that such agreements and understandings shall remain the legal basis (Rechtsgrund) for any performances (Leistungen) rendered under such agreements and understanding during their term.	A standard clause. In later financing rounds, it is recommended to have more precise rules around if and to what extent the investment and shareholders' agreements from earlier financing rounds shall be terminated. Please be careful here. It can also be clarified that with the execution of the definitive investment and shareholders' agreements, the term sheet put forward by the investor during the negotiation that led up to the financing round shall be deemed terminated.
AMENDMENTS	
It is standard to clarify that any provision of the investment and shareholders' agreement may be amended or waived if, but only if, such amendment or waiver is by written instrument executed by all parties unless a stricter form (*e.g.*, notarization) is required by law.	

25 We added "fax" here only to hear our US colleagues laughing. While standard language in many German market agreements still makes reference to communication by fax, even most Germans have meanwhile moved on. However, given that in the US, cheques are more often than not still considered a normal payment method, we should be even.

Boilerplate Clause	Comments
SUCCESSORS AND ASSIGNMENTS	
Likewise, it is standard to clarify that the provisions of the investment and shareholders' agreement shall be binding upon and inure to the benefit of the parties to that agreement and their respective successors and assignees. To avoid the "intrusion" of an unwelcomed third-party and to safeguard the share transfer restrictions, etc., no party may assign any of its rights or obligations under the investment and shareholders' agreement without the consent of the other parties.	When drafting the succession and assignment provision, it needs to be harmonized with the rules governing the acquisition of shares by new shareholders (*e.g.*, in a future financing round) and the accession of such new party to the investment and shareholders' agreements.
GOVERNING LAW	
Governing clause provisions are customary in investment and shareholders' agreements. The parties agree that the investment and shareholders' agreement and any noncontractual rights and obligations arising out of or in connection with it shall be governed by, and construed in accordance with, the laws of Germany.	As briefly noted above, a governing law clause may increase the costs for notarization of the investment and shareholders' agreement. In simple cases where it should be clear that German law applies, it might be helpful to draft the governing law clause in a manner that makes it clear that the clause shall be for clarification purposes only (*nur klarstellender, nicht konstituierender Natur*). However, the law does not differentiate between clarifying and constitutive clauses, and there is no decisive case law on the question of whether or not the increased notarization costs can be avoided by a mere clarifying governing law provision. Just like all matters that can possibly cause higher costs, this should be discussed with the acting notary in advance to avoid any unpleasant surprises later on. It should also be made clear that while German law applies, this shall exclude its conflict-of-laws rules as they may ultimately result in the application of other substantive laws than German law.
SEVERABILITY	
A severability clause states that should any provision of the investment and shareholders' agreement be or become invalid or unenforceable in whole or in part, the validity or enforceability of the other provisions shall not be affected thereby. Rather, the invalid or unenforceable provision shall be deemed to be substituted by a suitable and equitable provision which, to the extent legally permissible, comes as close as possible to the intent and purpose of the invalid or unenforceable provision. The same shall apply if the investment and shareholders' agreements should have unintended gaps (unbeabsichtigte Regelungslücken). Those shall be filled by provisions that come as close as what the parties would have agreed had they been aware of the gap.	This is another standard clause that should be included in any investment and shareholders' agreement. Please note that there are rulings by the German Federal Supreme Court (Bundesgerichtshof) whereby a severability clause merely reverses the burden of proof. Thus it makes sense to clearly state that it is the parties' express intention to maintain the validity of the remaining provisions of the investment and shareholders' agreement and avoid having the severability clause interpreted as a mere reversion of the burden of proof and exclude the applicability of sec. 139 German Civil Code as a whole – but that is only of relevance for those of our readers interested in the nuances of German civil law (we know you two are out there and this is out tribute for you).

VI. The Road Ahead

Let's admit it – we were wrong, indeed quite wrong. In the spring of 2020, we published OLNS#5 to prepare founders for the expected gloomy days ahead. With the ensuing COVID-19 crisis and an overall economy going headlong into recession, there was no way that this wouldn't impact start-up financing big time. And, indeed, COVID-19 had a massive impact. But what was initially expected to be the beginning of a nuclear winter turned out to be in many industries what historians might one day call the "Great Acceleration". Venture capital financings reached record highs in Germany. Although that rise was largely due to an increase in late-stage capital and the inflow of money from well-funded overseas investors, so far, start-up financing in Germany has shown remarkable resilience and now that data for the first three quarters of 2021 is in, the strong momentum seems intact and to have actually accelerated in many segments.

So, while the authors of this Guide decided to no longer try their hands at predicting the venture market, one of our co-authors – it is the one who predicted five of the last two market downturns and as a HSV supporter has always a pessimistic outlook on life – prepared the table below summarizing potential changes of the main economic and control terms in VC financings in a downturn market (does anybody even remember the old days of 2019 when we saw the first signs of median valuations in late stage financings coming down, but anyway).

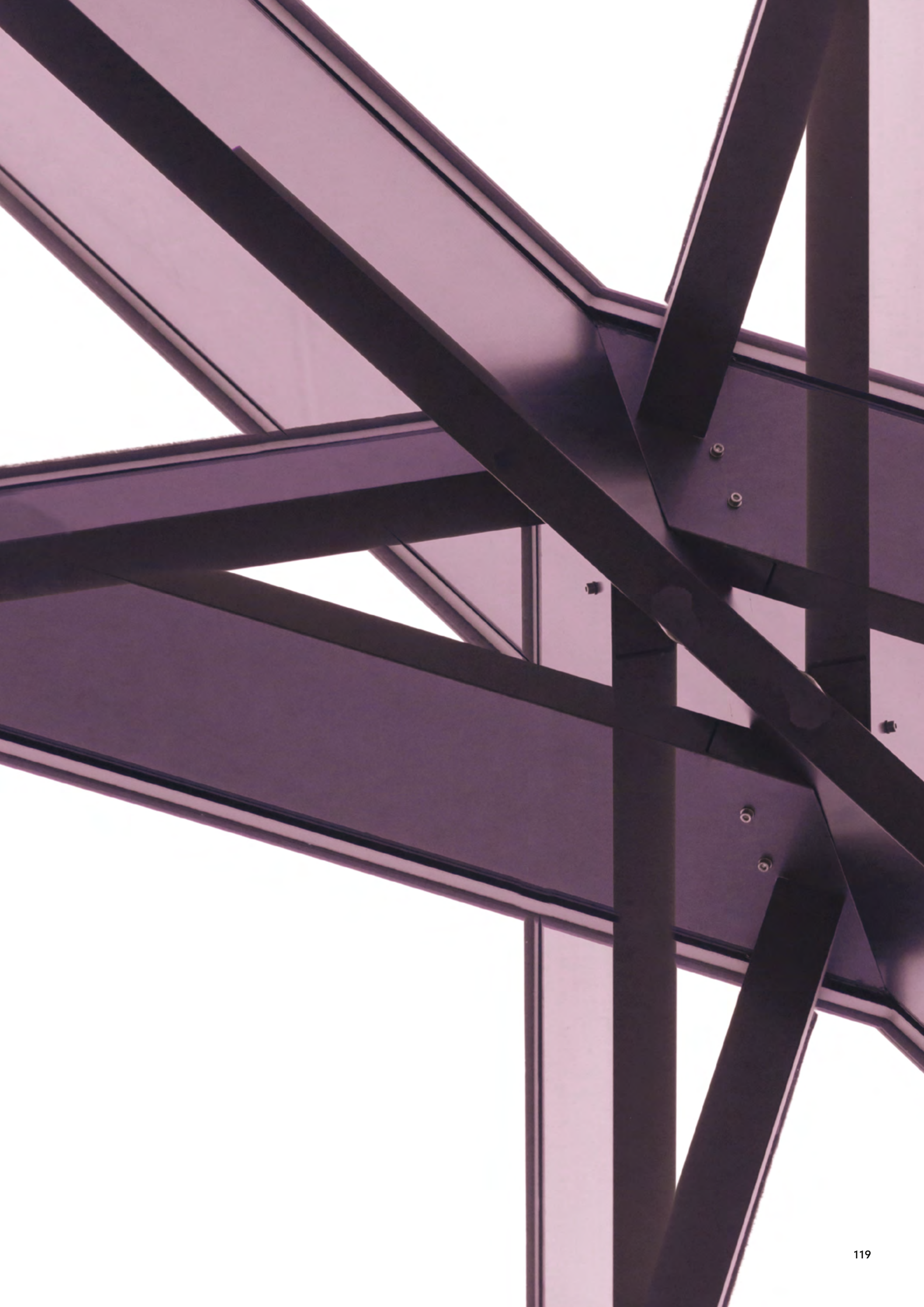
But given that we get our predictions wrong all the time, we will likely start the next edition of this Guide in a few years with a quote from one of the world's most famous entrepreneurs who began his 2001 letter to his shareholders as follows: "Ouch".

So, stay with us and most of all stay safe and keep founding and investing – you keep lawyers employed.

Potential Changes in Deal Terms in a Downturn Environment

	Clause	Market Standard Prior to COVID-19	Changes in a Downturn Market	Potential Compromises
Control	Veto Rights	While there was a term to more founder-friendly terms, overall German market approval catalouges were still pretty extensive	Even tighter restrictions can be expected	
Control	Forced Exits	Majority-initiated exit options were common	Minority-initiated investor exit options might get added	• Minority-initiated investor exits made subject to certain conditions (*e.g.* majority shareholder(s) do not initiate exit within certain time period) • Put options for minority shareholders at certain percentage of FMV in case majority shareholder(s) do not initiate exit within certain time period • Appointment of corporate financial advisor
Economic Terms	Tranched Investment Rounds	Rather uncommon	Installment payments in accordance with acheivement of certain milestones added	Particular importance should be given to a clean definition of the relevant milestones triggering the additional payments
Economic Terms	Liquidation Preferences	1x non-participating preference is the current standard	>1x and/or participating preference	• Capped participating liquidation preference • Multiple liquidation preference with a "catch-up"

	Clause	Market Standard in the Current Good Environment	Changes in a Downturn Market	Potential Compromises
Control	Anti-Dilution Protection	Broad-based weighted average clauses are most common	Move (return) to narrow-based or even full-ratchet clauses	• Time limit for full-ratchet, then weighted average (narrow-based) • Pay-to-play mechanisms • Management top-ups • "Narrow-based" clauses instead of full-ratchet (balanced approach) • "Half-ratchet" – half of the conversion price
Control	Pay-to-Play Provision	Rather uncommon	Added	
Control	Redemption Rights	Very rare in Europe, more common in the US	Due to legal restrictions on buy-backs / redemptions as well as uncertainties around accounting treatment, we do not anticipate these provisions to spread in Germany	



B. Our International Platform for Technology Companies

Dedicated to the needs of technology companies and their investors

Betterment | Cisco | Getaround | Microsoft NVIDIA | Oracle | Revolut | SoFi | Sonos | Stripe

Orrick counsels more than 3,000 tech companies as well as the most active funds, corporate venture investors and public tech companies worldwide. Our focus is on helping disruptive companies tap into innovative legal solutions.
We are a top 10 law firm for global M&A volume (*MergerMarket*) and the #1 most active law firm in European venture capital (*Pitchbook*).

The leading German legal data base JUVE **nominated** us **for Private Equity and Venture Capital Law Firm of the Year** in Germany 2021 and 2019, and named our partner Sven Greulich one of the top VC lawyers in Germany (2020/2021)

Tech Group of the Year
2018
Law360

Leader in Venture Capital and Corporate Practice
Legal 500

PitchBook

#1 Most Active
VC law firm in Europe
for 22 quarters in a row
PitchBook Q2 2021

Honored for Connecting the German Mittelstand with Start-ups

In its 2017 **European Innovative Lawyers Report**, the *Financial Times* awarded our German Technology Team a top three position in the category of supporting start-ups and innovation. In this Europe-wide and in-depth research, the *Financial Times* labeled our corporate venture capital initiative led by Düsseldorf partner Sven Greulich as *"outstanding."* In its reasoning, the *Financial Times* further stated: *"Connecting Germany's Mittelstand (mid-sized companies) with start-ups, the firm is tackling tax issues in stock option plans, making bridges between Silicon Valley and Germany, and showing the way for successful investments."*

The 2020 State of European Tech Report prepared by *Atomico* in partnership with *Slush* and Orrick and support from Silicon Valley Bank, is the latest evidence of Europe's growing influence in the global tech ecosystem.

A TRULY GLOBAL PLATFORM.

Lilium
on its $3.3bn De-SPAC as well as a prior $275m financing round

Coatue
as lead investor in Gorillas Technologies' $290m Series B

auxmoney
on its latest €150m financing round

Camunda Services
on its $100m Series B

Contentful
on its $80m Series E

WE ADVISE TECH COMPANIES AT ALL STAGES:

20% of all **$1 billion+ unicorns** in the US and UK markets

6 of the world's biggest **tech companies**

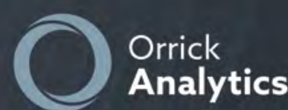
In 2020, advised on more than **920 VC financings** valued at **over $25.2 billion** for companies based in **45+** countries.

Operating in 25 markets worldwide, we offer holistic solutions for companies at all stages, executing strategic transactions but also protecting intellectual property, managing cybersecurity, leveraging data and resolving disputes. We are helping our clients navigate the regulatory challenges raised by new technologies such as crypto currencies, autonomous vehicles and drones. A leader in traditional finance, we work with the pioneers of marketplace lending.

We innovate not only in our legal advice but also in the way we deliver legal services, earning us the #1 spot on *Financial Times'* list of the most innovative North American law firms in 2017 and 2018, runner-up in 2019 and 2020 as well as most digital North American law firm in 2020.

Our clients demand ever-increasing levels of quality and value. So, we're transforming service delivery through staffing, technology and a deep understanding of client needs

Dedicated in-house team of technologists focused on creating leading-edge legal service solutions to enhance quality, security and efficiency



Bringing state-of-the-art technology and statistical analysis to litigation and transactional services

Improving Project Management for FIs

Built an online project dashboard and created a "playbook" to draft and negotiate agreements for hundreds of trades

Cutting Legal Services Costs

Worked with LendingClub to streamline compliance review's and cut volume and cost of legal support by about 50%

Creating First-of-a-kind-structures

Worked with Mercy Corps to develop the Community Investment Trust enabling low-income residents to invest in local commercial properties for future financial gain

DIRECT LENDING

Powered by Orrick

Only legal portal for the corporate direct lending community utilizing technology to provide simple solutions to common issues

Collaborated to streamline compliance reviews and cut client's volume and cost of legal support by about 50%

Derivatives in Review

Helping clients understand important legal and regulatory developments in the area of derivatives

Distressed Download

Latest news and industry trends in the distressed debt and restructuring markets

ORRICK CARES

Communities Worldwide

We share a firm-wide commitment to making a social impact. Our European pro bono and sustainability director has helped our teams provide 5,350 hours in pro bono service in the past year

INCLUSION & WELLNESS

Inclusiveness is a core value that shapes the way we run our firm. It's part of our daily conversation about investing in talent, staffing our teams and measuring our success

And we're committed to leading it. We're working to improve legal services delivery.

WE INNOVATE BY:

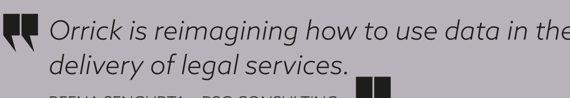
IMPROVING WORKFLOW WITH HUMAN-CENTERED DESIGN.

APPLYING ANALYTICS TO LEGAL PROBLEMS.

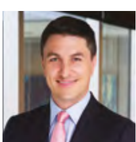
BRINGING GREATER CERTAINTY TO PRICING.

Innovation in Diversity and Inclusion

For the fourth year in a row, Orrick has been recognised by the *Financial Times* in its annual **Innovative Lawyers Report Europe** for various projects focused on delivering these innovative solutions. Overall, the Report ranks Orrick among the top five US-origin law firms in Europe.



C. About the Authors



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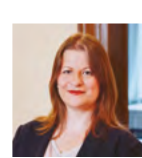

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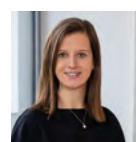

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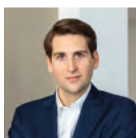
Ilona Schütz is an associate in our M&A practice group in our Düsseldorf office. She is advising young founders and technology companies. Ilona has special expertise in advising university spin-outs and is passionate about female entrepreneurships and helping the next generation of female founders to get their start-ups off the ground.



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D. Helpful Sources

Orrick Legal Ninja Series

OLNS #1 — Venture Debt for Tech Companies
May 2019

Venture Debt is a potentially attractive complement to equity financings for business start-ups that already have strong investors on board.

It is a highly flexible instrument with very little dilutive effect for founders and existing investors.

OLNS#1 focuses on Venture Debt and includes practical tips and legal considerations based on years of experience counselling high-growth companies and their investors across the globe.

Topics include:

- What is Venture Debt
- Advantages of Venture Debt Financing
- Disadvantages and Risks of Venture Debt Financing
- Customary Terms and Conditions and Drafting Tips

For emerging technology companies, gaining access to financial resources is a key challenge. Traditional bank loans are often unavailable, and the financial means of the founders are usually limited. An (equity) financing by institutional venture capital investors often represents the most expensive form of capital. Thus Venture Debt can be very attractive for emerging technology companies.

OLNS #2 — Convertible Loans for Tech Companies
August 2019

Due to their flexibility and reduced complexity compared to fully-fledged equity financings, convertible loans are an important part of a start-up's financing tool box. In a nutshell: a convertible loan is generally not meant to be repaid, but to be converted into an equity participation in the start-up at a later stage.

OLNS#2 is filled with practical tips for founders and investors alike and comprehensively presents all the essentials you need to know about convertible loans, including:

- Advantages and Disadvantages of a Convertible Loan Financing
- Material Terms and Conditions of a Convertible Loan Agreement and Drafting Tips
- Convertible Loans and Notarization
- Tax Considerations (Germany)
- Public Subsidy Programs for Convertible Loan Agreements
- SAFEs

Convertible loans belong to the group of mezzanine or hybrid financing instruments and are generally not tied to certain stages of the life circle of the start-up as borrower. Convertible loans must be distinguished from convertible bonds and venture debt financings, the latter of which are described comprehensively in our OLNS#1 Venture Debt for Tech Companies.

OLNS #3 — Employment Law for Tech Companies
December 2019

Young technology companies are focused on developing their products and bringing VC investors on board. Every euro in the budget counts, personnel is often limited, and legal advice can be expensive. For these reasons, legal issues are not always top of mind. But trial and error with employment law can quickly become expensive for founders and young companies.

OLNS#3 contains employment law must-haves for young technology companies in Germany and key issues for start-ups to watch out for in the US OLNS#3 covers:

- Different staffing options — employees, fixed-term contracts, independent contractors, trainees, working students
- Properly classifying your team members as employees or independent contractors — in Germany and the US
- How to draft your first employment contract (and what to watch out for if you take templates from the Internet)
- The many pitfalls of the oh-so-popular fixed-term contracts
- When you can use DocuSign (and when not)
- How to use the probationary period wisely (and to properly prepare dismissals if things don't work out)
- How to use non-competes and retention payments to protect the company's know-how

We have many years of experience helping German and international technology companies at every stage of the life cycle — from hiring their first employees, through several financing rounds, to IPO.

OLNS #4 — Corporate Venture Capital
March 2020

Corporates are under massive pressure to innovate to compete with new disruptive technologies and a successful CVC program offers more than capital — access to company resources and commercial opportunities are key features that justify CVC's prominence. This guide serves to share best practices for corporates and start- ups participating in the CVC ecosystem and also to ask important questions that will shape future direction. OLNS#4 is filled with practical tips for corporates and founders alike and comprehensively presents CVC motives, success factors, incentive schemes and tips for agreements, including:

- Forms of corporate venturing and its dual focus — learning vs. earning
- Current landscape and trends
- Benefits and downsides of CVC from both the corporate's and the start-up's perspective
- How to organize CVC activities, main challenges and common mistakes
- What to look for when hiring external VC and CVC talent
- Incentive schemes
- Cooperating with the corporate's other business units
- Sourcing and making deals
- The in-house legal team's role and the investment playbook
- Special deal terms for CVC investments and compliance considerations

OLNS #5 — Venture Financings in the Wake of the Black Swan
April 2020

Headed into 2020, start-ups accustomed to easy venture capital ("VC") dollars already faced leaner times, with VC funding having already cooled in Q4/2019. And then along came COVID-19...When you consider the shock waves this pandemic sent around the globe, how it sent the capital markets into chaos and affected both the demand as well as the supply side of almost every industry in every major economy around the globe, the current situation looks like a "perfect storm."

OLNS#5 contains some of our observations on the most recent developments in venture financings and gives guidance for fundraising in (historically) uncertain times, including:

- Brief overview of the current fundraising environment
- Lessons learned from the last two tech crashes
- Potential impact of the COVID-19 crisis on CVC investors
- Likely changes in deal terms and structural elements of financings
- Employee participation programs

OLNS #6 — Leading Tech Companies Through a Downturn
May 2020

Downturns can be challenging for any company, but the current COVID-19 pandemic shows once more (as the financial crisis did in 2008 and 2009) that the effects of such a crisis on start-ups can be particularly severe. Collapsing investments and loss of sales can quickly become a threat to their existence, and founders must react quickly and effectively to the multiple challenges they are facing such as: What obligations of the start-ups must its managing directors monitor in a downturn? Which personal liability risks are involved? What happens to the employees and how do you deal with a potential loss of workflow, disrupted supply chains, unpaid invoices and the looming threat of insolvency?

These are only some of the questions that founders have to deal with in the current, and in any other economic crisis. Therefore, following OLNS#5, that focuses on the challenges of raising venture financing in the wake of the COVID-19 pandemic, OLNS#6 gives a comprehensive overview of some of the most important topics that start-ups and founders may need to deal with during a downturn and, of course, especially in the current COVID-19 pandemic. It remains to be seen what damage this crisis will actually leave behind, but one thing is clear: as with every economic crisis, once we are through this, there will be a new era with new opportunities. With this Guide, we therefore want to demonstrate how start-ups and founders can get prepared for after the crisis and thus invest in their future.

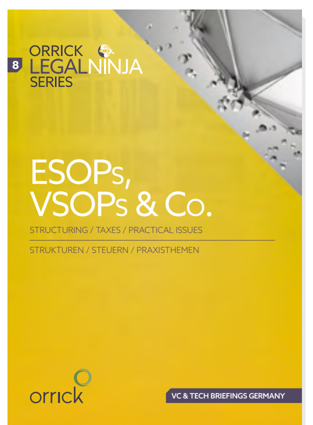
Orrick Legal Ninja Series, cont.

OLNS #7 — Flip it Right: Two-Tier US Holding Structures for German Start-ups
January 2021

We are often asked by founders and investors of German start-ups whether they should flip their German technology company into a US (usually Delaware) holding. This structure comes with a variety of benefits, most notably an arguably better access to early stage financing opportunities in the richer US funding ecosystem. Other advantages include improved exit opportunities as well as the opportunity to offer a "Silicon Valley" style equity-based employee participation program to suitable talent. However, doing the flip is a major corporate undertaking that includes a variety of potential drawbacks and requires close cooperation between founders and existing investors as well as advise from legal, accounting and tax experts with experience on both sides of the pond.

Nevertheless, we think that it makes sense for German start-ups to consider a US/German two-tier structure early on in their lifecycle as a later stage flip usually becomes more complex and tax expensive. To help German start-ups with this exercise, we published OLNS#7. OLNS#7 shares our experiences from numerous flip engagements and gives guidance on the following topics:

- the pros and cons for German start-ups having a two-tier structure
- options regarding how to establish a two-tier structure
- tax considerations, both with respect to the flip itself and also regarding the time after the flip
- operating in a two-tier structure
- fund raising in a two-tier structure



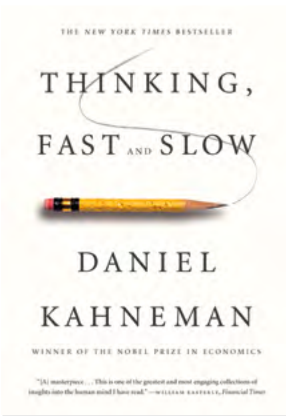
OLNS #8 — ESOPs, VSOPs & Co.: Structuring / Taxes / Practical Issues
June 2021

OLNS#8 provides a comprehensive overview of the equity-based and virtual programs that German start-ups have at their disposal. While instinctively most founders understand that giving employees a slice in their company is important, many struggle in identifying the best approach to employee ownership for their specific situation. With OLNS#8, we want to help start-ups and investors alike to better understand what employee ownership is, structure them in a way that is congruent with incentives, and implement them cleanly. Drawing on our experiences from working with thousands of start-ups worldwide, we will also give guidance on some practical challenges that many start-ups face at some point, *e.g.*:

- how to use their employee-ownership programs for international hires;
- how to account for the program's liabilities; and
- what to keep in mind when looking at the interplay between employee-ownership programs and financing rounds or M&A transactions.

ACCESS THEM HERE:
https://www.orrick.com/en/Practices/Orrick-Legal-Ninja-Series-OLNS

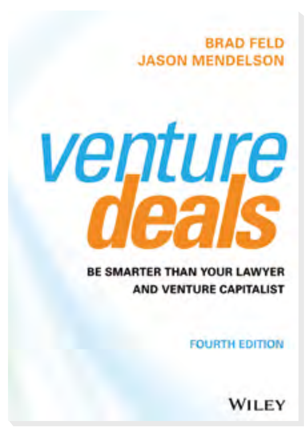
Books



Thinking, Fast and Slow

Daniel Kahneman
Penguin, 2012

In this international bestseller, Nobel Prize winner Daniel Kahneman distils a lifetime of groundbreaking behavioral economics research into an encyclopedic yet lucid coverage of the heuristics and biases that influence our supposedly rational decision-making processes.



Venture Deals – Be Smarter Than Your Lawyer and Venture Capitalist

Brad Feld & Jason Mendelson
4th edition, John Wiley and Sons, 2019

Although focused on US start-ups and venture-capital deals, this "classic" is a must-read for each generation of new entrepreneurs. In addition to describing venture capital financings in detail, it provides context around the players, the deal dynamics and how venture capital funds work. Plus, it makes fun of lawyers!

Secrets of Sand Hill Road: Venture Capital – and How to Get It

Scott Kupor
Portfolio, 2019

Lawyer-turned-entrepreneur-turned-VC, Scott Kupor is a managing partner at the famous investor Andreessen Horowitz. He gives a detailed yet entertaining introduction into how VC investors think and come to their investment decisions.

Another Orrick Guide that may interest you

To help German founders understand and navigate the US market, Orrick has launched its **Go West Guide** and meanwhile published its updated and expanded 2nd edition.

Over close to 100 pages, it provides practical tips and legal considerations based on years of experience counseling high-growth companies in the US, Germany and worldwide:

- When and how to look for US investors
- Key differences of funding rounds in Germany / the US
- How to "flip" a German GmbH into a US company — and the pros and cons
- Key operational considerations
- Unique US market risks, *inter alia* trade secrets and litigation.

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