

Orrick's Guide to
Venture Capital Deals
in Germany

2018 Edition





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Introduction

Negotiating venture capital financing agreements for privately held technology companies 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 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. 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.

This Guide discusses many of the most-contested issues in venture financings, presenting both the investor's and the founder's perspective. It aims to provide stakeholders in a young technology company, who are often unfamiliar with the venture capital process, with a guide. We will give an outline of venture deal structures, the industry terminology and some of the concepts and terms frequently used in term sheets and the fully fledged investment documentation. Venture capitalists 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 have dedicated technology lawyers in all major world markets 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 United States and German entrepreneurship ecosystems closer together. 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 U.S. or U.K. 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 U.S. and the U.K. so that this Guide may also serve as a useful tool for investors from these jurisdictions considering investments in young German technology companies.

In **Chapter A**, 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 venture capital investors later on.¹ In this first chapter, we will also give an overview of the most relevant legal topics that an investor will cover in its 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, including the term sheet, the investment agreement and the shareholders' agreement as well as some other ancillary documents.

Chapter B presents the most relevant provisions found in a typical German market investment agreement. After a brief introduction to the concepts of pre- and post-money valuation, we 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.

Chapter C dives into the most material provisions usually found in the shareholders' agreement. Many of these provisions fall into one of two categories: terms related to control and terms related to economics. In the first bucket are provisions regarding 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.) The second bucket comprises provisions such as antidilution, preference rights regarding dividends and liquidation proceeds as well as founder vesting clauses. In addition, we will present other relevant provisions, including dispute settlements,

employee participation programs, matrimonial regimes (a German law particularity that can cause a lot of headaches down the road) and much more.

In **Chapter D**, we include a template term sheet, while in the remaining **Chapters E** and **F**, we briefly introduce our international platform for high-growth companies as well as the authors of this Guide.

Throughout the Guide, we toss in sidebars labeled "A Closer Look," covering certain topics in greater detail, including key terms for convertible loans, the increased importance of data privacy rules, merger clearance for venture capital investments and technology exits, and key terms for virtual stock option plans.

By necessity, this Guide will not be appropriate for every financing round, as each company and investor is different. This Guide cannot substitute proper advice by a qualified lawyer on a case-by-case basis, but it should cover most of the terms typically used in the German market today.

We hope you enjoy this Guide. If you would like to discuss it further, please get in touch. We would also love to learn about your experiences with these topics. So please share them with us. We constantly strive to evolve and grow in order to best serve our clients.

On behalf of the Orrick Team,

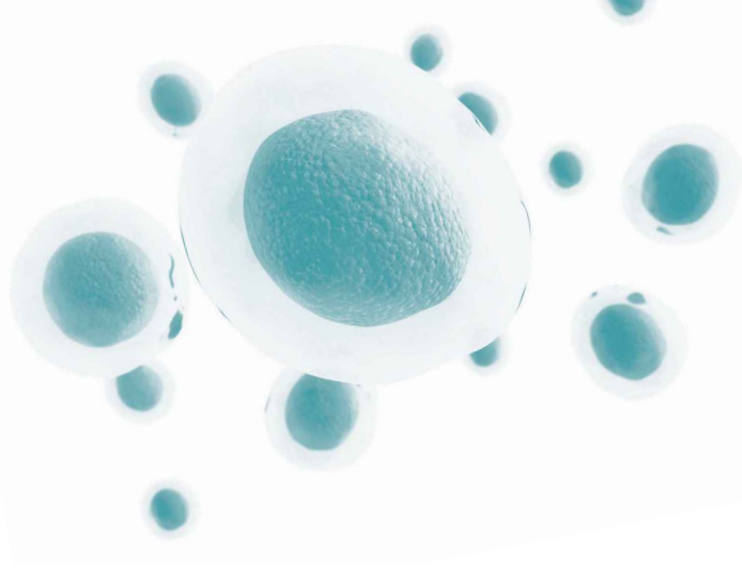


Sven Greulich

Orrick - Technology Companies Group Germany

¹ We are, of course, aware that institutional venture capitalists are only one source of funding for aspiring German technology companies and that funding from large and medium-sized corporations (including the German *Mittelstand*) becomes an ever more important funding source in Germany. For simplicity's sake, we use the term "venture capital investor," or simply "investor," throughout this Guide to include both institutional and corporate investors. The interests of corporate venture capital investors and "classical" venture capital funds may differ, most notably when the corporate investor pursues primarily strategic rather than financial goals. These differences may ultimately result in different deal terms for venture capital and corporate venture capital financing rounds (though according to our experiences, these differences are in practice less relevant, especially when — as it is most often the case — corporates and venture capitalists invest alongside each other.) If you are interested in corporate venture capital in particular, please see our special guide *Corporate Venture Capital 2017 - Structures, Challenges & Success Factors*, Orrick, Herrington & Sutcliffe, July 2017, available at: <https://www.orrick.com/Insights/2017/06/Corporate-Venture-Capital-2017>.

A. Getting Started



I. Setting Up the Company

In the well-known start-up guide *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."

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.

Here's why. Instead of hiring a qualified lawyer, founders download investment documents from various sources on the web and stitch them together. Not seldom, such documents are intended for use in the U.S. and simply don't square with the rules applicable to German limited liability companies (*Gesellschaft mit beschränkter Haftung - GmbH*).² Sometimes, we even see lawyers who market themselves

as experienced venture capital advisers do the same. In other cases, founders blindly accept the deal documents presented to them by supposedly sophisticated angel investors or some early-stage venture capitalist. The problem with this latter approach is that founders may accept onerous provisions unsuitable for an early-stage investment and with long-term negative consequences for the company.

Against this background, we want to highlight in this chapter frequent pitfalls that we encounter time and time again when advising on early-stage financings.

² Most German high-growth technology companies are organized as a GmbH, and very early stage companies may be organized as a "UG (haftungsbeschränkt)," which can be understood in a nutshell as a "GmbH light." It is less common to set up the company as a German stock corporation (*Aktiengesellschaft*.) However, the German law provides for options to change the form of a company at a later stage, e.g., to convert a GmbH into an *Aktiengesellschaft* in preparation of an IPO as a GmbH is not eligible for a stock exchange listing. Throughout this Guide we concentrate on investments in a German GmbH as this is by far the most relevant scenario for venture capital deals in Germany.

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), often referred to as a *founder holding company* or short *founder HoldCo*.³ While holding one's participation through a founder HoldCo makes the shareholders' agreement a little more complex and incurs some costs for setting up and maintaining a separate legal entity, it is worth thinking about an adequate holding structure early on, as changing from a one-tier to a two-tier structure at a later point in time can have negative tax consequences.

The main reasons for adopting a two-tier structure are tax benefits. We 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.



Founders should think about a tax-optimized holding structure early on.

Taxation of Capital Gains (from a Sale and certain Share Swaps such as a "U.S. Flip")

A two-tier structure offers tax advantages if the founder wants to sell her⁴ participation in the company. In a one-tier scenario, she would incur up to 28.5% personal tax cost on capital gains when she sells her participation in the company. Using a two-tier structure, however, would allow the founder to reduce the taxation on capital gains from selling her participation in the company to effectively 1.5%: The founder

HoldCo is eligible for a 95% tax exemption on capital gains. The remaining 5% is taxed at approximately 30% aggregate corporate taxes, reducing her tax to 1.5%. Church tax would still come on top in the one-tier scenario but would not accrue to capital gains in the two-tier scenario.

If the founder then wants to enjoy the gains from the exit and pay out a dividend from the founder HoldCo to herself, this would neutralize the tax advantage of the two-tier scenario. 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 the founder HoldCo in other ventures or assets (shares, property, etc.). Also, the two-tier structure allows the founder to determine the point in time when the tax on the distribution accrues. In the one-tier scenario, the tax would accrue upon the divestment of the shares in the company by the founder.)

Taxation of Dividends

Similarly, the two-tier structure can offer tax advantages if the company pays dividends to its shareholders. In a one-tier scenario, taxation on the personal level may go up to 28.5%, excluding church tax, whereas in a two-tier scenario, the tax burden would be limited to 1.5%, but only if the founder HoldCo holds at least 15% of the nominal capital of the company. Should the founder HoldCo be at risk of being diluted below that level, and if dividends are a serious option, then two or more founders (or any other shareholder) may

³ In Germany, the 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.)

⁴ 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.

pool their HoldCo's participations through another joint HoldCo. This would, in effect, establish a three-tier structure, where the lower-level HoldCo holds a joint shareholding of 15% or more of the nominal capital of the company, and benefits 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.

Here is an example that illustrates how this works: Founders A and B, each through a wholly owned subsidiary, hold 40% of a holding company while the remaining 20% in that (lower-level) holding company is held by

a seed investor through its holding company. The founders' and seed investor's joint holding company, in turn, holds 18% in the start-up. In this example, no holding company (both on the upper level and the lower level) holds less than 15% in its direct subsidiary and is eligible for the above-described tax benefits, although economically, A's and B's holding companies "only" hold a 7.2% interest in the start-up each and the seed investor "only" holds a 3.6% interest. The low 1.5% effective taxation applies on every corporate level nonetheless.



A CLOSER LOOK:

Taxation Issues When a Founder Moves Abroad

Income tax may accrue on untaxed reserves in founders' shares if the founders leave Germany and move to a foreign country – the so-called exit taxation (*Wegzugsbesteuerung*.) Exit taxation is typically an issue if the founder has held a participation of one percent or more in the capital of a corporation at any point in time during the last five years and if she has had a German domicile for ten years in her life. Under the exit taxation rules, capital gains may be taxed at the founder's level at up to 28.5%, excluding church tax. Not good, given how liquidity-strapped founders usually are.

Example: Two founders each hold a 50% share in their start-up. Their respective acquisition costs for the shares amount to EUR 12,500 (*i.e.*, 50% of the minimum capital amount that you have to put on the table when setting up a GmbH.) After several financing rounds, the start-up shall expand to the U.S. One of the founders, whose shares are worth EUR 1,000,000 based on the valuation of the latest financing round, shall relocate to the Bay Area to help develop a credible "Silicon Valley story." The move from Germany to the U.S. may trigger taxes at an amount of more than EUR 280,000 (*Teileinkünfteverfahren*) even though no shares have been transferred at all.





A CLOSER LOOK:

Taxation Issues When a Founder Moves Abroad (cont.)



Exit taxation can be avoided by the founder in certain cases. One way is the use of a partnership with a continuous German management site and managerial functions in the start-up as a new holding entity. Another way would be the conversion of the start-up itself into a partnership. However, these two options will typically be highly unattractive for investors and are therefore not available in practice. This leaves the founders with some remaining options to mitigate the exit tax burden or to defer the time of payment:

- The founder maintains a domicile or a residence in Germany (can be as little as a room in her parents' house with the keys to it, depending on the concrete circumstances) and visits Germany from time to time. The closer her overall relations with Germany, the more feasible it may be to demonstrate that the founder really has not moved the center of life interest out of Germany. With the center of life interest still in Germany and depending on the destination country's double tax treaty with Germany, the founder may argue that taxwise she has not left Germany after all, and, hence, no exit tax accrues (most notably, the U.S. treaty would follow that logic.)
- Without the prospect of maintaining a German domicile or residence, the founder (i) plans a leave either to an EU/EEA country and is a citizen of an EU/EEA country or (ii) plans a temporary leave from Germany of not more than five years (term can be prolonged if the leave is strictly for professional reasons.) In these cases, the founder can apply for deferral of tax payments (possibly against security) with the tax authority. The tax will be cancelled if the founder returns to Germany within the aforementioned term and will, alternatively, typically only be collected in an exit (or sales-like scenarios.)
- In the absence of the aforementioned scenarios, the founder can apply for deferral and/or prorated payment of the exit tax if she can demonstrate that immediate payment would cause relevant hardship. Here, the tax authorities have wide discretion as to the details of the prorating.
- Another issue to look at when a founder moves abroad is the start-up's central place of management. For German tax reasons, it's best not to move the company's central place of management to the founder's new location. This can sometimes happen involuntarily, but it is less likely to happen if the company removes the founder from her executive director's post to a supervisory role and/or puts in place a new manager who credibly makes the majority of management decisions "at home."

2. The 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, options and convertible securities held. To give a complete picture of the economic participations in the company, the cap table may also contain the allocated virtual shares under a typical German

market virtual employee stock option plan (for details of such plans see below under Chapter C.VII.2). Although virtual shares 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 resulting from liquidation events.



Differences to U.S. and U.K. Investments: Transparency of Shareholdings

In the U.S., there is no shareholder register publicly available for privately held companies. In the U.K., 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 German 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. 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.

Recently, the German legislator has tightened the transparency requirements by introducing a general transparency register (*Transparenzregister*.) German limited liability companies, joint stock corporations and many other entities (including private equity funds) must make inquiries about their so-called beneficial owners and file their beneficial owners with the new 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. 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 more regulated: Businesses and individuals will be allowed to access it to the extent necessary to comply with their obligations under the German anti-money laundering rules. Apart from these situations, access by private parties (including, e.g., the press) requires demonstration of “legitimate interest.” Certain authorized public authorities have unrestricted access to the transparency register.

“Messing up the cap table” summarizes a phenomenon we sometimes see in very 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).

Having too many small shareholders in the cap table can create problems down the road. 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 nonvoting shares, which is not very common in Germany) vote their shares and challenge resolutions adopted by the shareholders’ meeting.

Professional venture capital 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 investment and shareholders’ agreement (for an overview of these agreements, please see below under Chapter A.III). If the existing minority shareholders do not come along and also enter into the new agreement, this can impact the new financing rounds 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 company 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 acting as a pool leader. 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 lead investor, it can be ensured that all 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. The convertible loan agreements should contain a provision that requires all lenders to adhere to the investment and

shareholders' agreement with the new investor in the next financing round when the lenders convert their loans into equity, which will set forth the rules of engagement for the minority shareholders as well. In addition, if a lead investor can be identified, a provision can be included in all convertible

loan agreements requiring the lenders to enter into a pool agreement with the lead investor upon conversion of the loans.



A CLOSER LOOK:

The Convertible Loan

1. What Is It and When Does It Make Sense?

While classical loans are paid back in cash, convertible loans (*Wandeldarlehen*) are, under certain circumstances, converted into shares in the company, such that the creditor (loan holder) becomes a co-owner (shareholder.) There are mainly two scenarios where it makes sense to structure a start-up investment through a convertible loan:

- In very early-stage investments when establishing valuation is cumbersome and the parties cannot reach an agreement on the "right price." With a convertible loan, the parties can defer the valuation question to a later date, *i.e.*, the next financing round when more information is available and the new investor and the founders have agreed on a valuation of the company. This financing round pre-money valuation minus the discount (see below) is then also binding for the conversion of the loan into equity.
- When a new financing round is near and the company needs some liquidity infusion to bridge the time until the new financing round closes.

The table below summarizes the main advantages and disadvantages of a convertible loan investment.

	Advantages	Disadvantages
Company's and Founders' Perspective	<ul style="list-style-type: none"> • During the term of the loan agreement, the investor has no shareholder rights and the founders do not get diluted. • Difficult valuation discussions can be deferred to the next financing round (particularly helpful in very early phases of a start-up.) • Transaction costs for a fully fledged financing documentation (including investment and shareholders' agreement) can be avoided, as only a convertible loan agreement is required. 	<ul style="list-style-type: none"> • If the company cannot request the conversion of the loan agreement, this might negatively impact future financing rounds. • If no conversion occurs, the loan needs to be paid back with interest.
Investor's Perspective	<ul style="list-style-type: none"> • Difficult valuation discussions can be avoided. • Transaction costs are limited (see above.) • If interest can also be converted into equity, this will increase the investor's stake in the company. 	<ul style="list-style-type: none"> • Prior to the conversion, the lender has no shareholders' rights but only the contractual rights specifically agreed upon in the loan agreement.





A CLOSER LOOK:

The Convertible Loan (cont.)

••• 2. Does It Need to Be Notarized?

We are often asked whether under German law a convertible loan agreement that shall be extended to a company organized as a GmbH or UG (haftungsbeschränkt) needs to be notarized or if written form is sufficient for its effectiveness. The answer to this depends on the circumstances and can be broadly summarized as follows:

- If, as recommended (see below), all shareholders sign the loan agreement, recent case law tends to assume that the loan agreement (including the voting agreement among the shareholders to procure the necessary capital increase) *per se* does not need to be notarized. This holds true whether the investor is already a shareholder or will only become a shareholder upon conversion of the loan.
- However, please note that most loan agreements include a binding obligation of the investor to subscribe for shares in the company (mandatory conversion in certain scenarios.) Here, case law is ambiguous as to whether this obligation needs to be notarized. To avoid legal uncertainty, the parties should notarize the undertaking as a matter of precaution. This is one of the reasons that when there are more substantial sums involved, convertible loan agreements tend to get notarized in Germany.
- In case the loan agreement is concluded by the company as borrower and the lender alone, and the existing shareholders are not a party to the agreement, the agreement itself does not need to be notarized. However, the company can only effectively conclude the agreement if there is an authorizing shareholders' resolution. The latter should, as a precaution, be notarized, since there is no conclusive case law on this question yet.

3. What Are the Key Terms to Consider?

Parties

- In many cases, it is advisable to have all shareholders sign the loan agreement, as only they can effectively resolve the capital increase required to convert the loan receivables into equity.
- If the company has an authorized capital (*genehmigtes Kapital*) – a feature that has become available for German GmbHs a couple of years ago but is still not as common as it is for German joint stock corporations – it would theoretically suffice to have only the company as borrower and the investor as lender become parties to the loan agreement. With an authorized capital, the management board of the borrowing company is able to issue shares, which is a requirement to convert the loan receivables into equity, without requesting the shareholders to resolve upon a capital increase. However, the investor would still face the theoretical risk that the shareholders might waive the authorized capital during the term of the loan agreement.

Loan Amount and Disbursement

- Loan amount and rules governing the disbursement of the loan amounts. Shall the loan be paid out only in tranches, and if so, shall the tranches be subject to the achievement of certain milestones (*i.e.*, shall the financing be staged)?

Interest Rate

- Usually, there is a rather high (risk-adjusted) interest rate; currently we often see rates between 8-10% p.a.
- Interest usually becomes payable only at the end of term to save the company's liquidity.





A CLOSER LOOK:

The Convertible Loan (cont.)

••• Term

- Unless the loan is granted as a short-term bridge loan, convertible loan agreements often have a term between two and four years.
- There is usually an extraordinary termination right upon the occurrence of a change-of-control or a conversion event.
- Investors should make sure that the company has no right to unilaterally repay the loan prior to the expiration of the term (in order to avoid a conversion).

Change-of-Control and Exit

- What happens if, during the term of the loan, a change-of-control at the company or another kind of exit (e.g., an asset deal involving all substantial assets of the company) occurs?
- The lenders can be granted the right to convert the loan receivables into equity shortly before the exit at the valuation of the exit (potentially minus a discount) and participate in the exit. Alternatively, the loan agreement could provide for an extraordinary termination right in case of a change-of-control or an exit coupled with an equity-like “kicker,” e.g., the repayment amount could be increased to a certain multiple of the original loan amount. This latter option makes the exit process less complicated.

Conversion

- Conversion events are usually the end of a specified term or the occurrence of a (qualified) financing round with outside investors and/or sometimes the occurrence of a change-of-control or an exit (see above).
- In case of a (qualified) financing round, the lenders convert their loan receivables into equity upon the valuation agreed with the investor minus a discount (often 15-25%) and sometimes subject to a certain valuation cap. In case of a conversion at the end of term, the loan agreement needs to either stipulate a specific company valuation for the conversion or provide for some formula for how the value of the company shall be determined for conversion purposes.
- Will accrued interest also be converted into equity or paid back in cash? Sometimes we have seen convertible loans that do not accrue any interest if a (qualified) financing round occurs within a certain rather short period of time after the loan has been granted.
- Is the conversion mandatory for the lender? Does the company have a right to request a conversion? The latter is often advisable, as an incoming new investor will often want to “clean up” the existing convertible loans and get the lenders into the equity and have them become parties to the new investment and shareholders’ agreement.
- Usually the lenders will request to receive the same class of shares as the incoming new investor, i.e., with the same preference rights.
- It is advisable to include an obligation of the lender to adhere to an investment and shareholders’ agreement and/or pool their rights (see above under Chapter A.I.2).

Other Provisions

- Will there be information and monitoring rights (relevant only for lenders that are not already shareholders)? Will the lender have veto rights for certain actions of the company?
- Convertible loan agreements usually contain a standard subordination clause (*Rangrücktrittsvereinbarung*) so that the loan receivables do not need to be taken into account when evaluating whether the company is overindebted (*überschuldet*) within the meaning of the German insolvency laws.

3. Future Financeability of the Company

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 also in deal terms. 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. Early-stage investors and the founders should be aware that everything they agree to in the first financing round will form the basis for corresponding provisions in the subsequent rounds. In particular, all later-stage investors will likely request at least the same preference rights as the early-stage investors and potentially more.

Here are just a few pitfalls founders and early-stage investors should be aware of:

Layers of Fully Participating Liquidation Preferences

While we describe liquidation preferences more fully later (see under Chapter C.III.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 participating liquidation preference (*nicht anrechenbarer Erlösvorzug*). As we will see, fully 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.



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 fully participating liquidation preference for their small investment amounts, they should be aware that this will set the tone for liquidation preferences that later-stage investors will request for their 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 unless a large exit valuation occurs. 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, *i.e.*, situations in which a motivated founder team is especially important. 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*.) 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. 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 — as it is realistic — one assumes that

terms of later-stage financing rounds are often inherited from the early rounds.

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, a 1x nonparticipating liquidation preference (for details see Chapter C.III.3).

Excessive Preemption Rights on New Shares

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 *prorata* holding, under the same terms and conditions as the shares are offered to new outside investors. This 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; for details, see further below). Some investors might demand to have a multiple on their preemption right (a so-called *super prorata right*) or even 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 be careful when it comes to agreeing on preemption rights and make sure that the financing documentation contains adequate provisions as to when the preemption right must be waived. 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 *prorata* subscription right with the above-mentioned exceptions should be an adequate compromise. 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 C.I.2) requests such a waiver.

Have Pay-to-Play Provisions Where 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 *prorata* 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 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 (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. Intellectual Property Rights

In tech start-ups, especially “digital start-ups,” the intellectual property rights, or “IP rights,” are oftentimes the main reason for the investment. Consequently, due diligence for such start-ups will be even more focused on issues around IP. The investor wants comfort that the company is the sole and exclusive owner of each item of the IP rights purported to be owned by it and that such IP is not subject to any encumbrances or limitations that unduly restrict the company’s ability to exploit it (or that reduce the value of that IP in the future) or give third parties rights to such IP (currently or as a result of the financing). The investor will also want to know that the company has the appropriate rights, through a license (exclusive or otherwise) or other contractual arrangement, to use any IP owned by third parties that is material to the company’s business. Finally, the investor will want to know if the company is subject to any pending or threatened legal proceedings challenging its IP or exposing the company to significant damages or loss of its IP, including, in particular, patent or trademark infringement claims.

Although most entrepreneurs have heard about IP-related mission-critical disputes such as the *Winklevoss twins’* disputes with *Mark Zuckerberg* and *Facebook*, IP issues are ubiquitous in start-up land. There are many pitfalls that await the unwary. As different rules apply to different types of IP rights and the rules differ across jurisdictions,⁵ certain rights might be forfeited if appropriate measures are not taken to secure and protect them.

In order to avoid some common pitfalls when it comes to IP and help investors check the box in this particularly important part of their legal due diligence, here are a few tips that every young technology company should follow right from the start:

- Develop and implement an *IP strategy* and begin building up an *IP portfolio*. The founders must have a good understanding about what kind of IP rights exist and which are relevant for the kind of business the company operates in. Founders must also understand how these rights can be protected and which formal steps must be taken to secure certain IP rights and maintain protection over time. For example, just registering trademarks for company names, logos and product names may not be sufficient. German trademarks must be used within five years after registration. If they are not used within that period in the form in which they are registered, the trademarks can be cancelled upon application of a third party (“use it or lose it”);
- One of the most important steps toward building a robust IP portfolio is to make sure that any IP that founders, directors, employees, consultants and freelancers develop in their work for the company is actually transferred to the company. It is essential to have legally binding agreements in place that include adequate IP (transfer) clauses. For example, one of the first things many founder teams come up with is a name for the company while still in the pre-incorporation phase. Rushing to protect the name of the future start-up, trademarks

⁵ For German technology companies, this becomes particularly relevant when expanding to the U.S. market. For an overview of how to protect one’s own IP rights in the U.S. and some particularities of the U.S. market, see our special guide *Go West: Venture Financings and Expansion Projects in the United States - Practical Guidelines for German Technology Companies*, Orrick, Herrington & Sutcliffe, July 2017, available at: <https://www.orrick.com/Insights/2017/07/Go-West-Venture-Financings-and-Expansion-Projects-in-the-United-States>.

and domain names are then registered by one of the founders herself. All might be fine until the prospective investor comes along and starts asking questions. If the founder who is still the registered owner of the respective IP rights left the company, or if the other founders have already started to push her out, the situation can quickly become very murky. Also be aware that the legal requirements may differ from country to country, e.g., a typical German market IP transfer clause may not be sufficient when the company outsources software development to programmers outside Germany;

- Be careful when using *open source software*. The license agreements applicable to many open source software may require the company (i) to disclose any of the self-developed source code to third parties, and/or (ii) to utilize and/or distribute software under the terms and conditions of the license applying to such open source software, and/or (iii) to permit third parties to utilize software which is combined or distributed with such open source software components (copyleft effect.) The company should also make sure that the use of any open source software components is adequately marked and documented according to customary industry standards (*i.e.*, in the form of in-line comments in the source code), including a reference to the relevant terms and conditions of the licenses that apply to such open software components;

- Protect your *know-how*: The broader term "know-how" includes information which relates to the business operations of the company and which is generally not known to the public but which is of particular relevance for the company. This might include, for example, procurement, research and development, production, information technology, quality management, marketing, logistics, sales and distribution and customer relations. Here, secrecy creates value. A basic know-how protection system includes, for example, (i) a consistent use of a brief but precise nondisclosure agreement when disclosing confidential information to third parties, (ii) accurate record keeping of the company's know-how, (iii) educating the company's employees about the importance of protecting the company's know-how, and (iv) clear policies to keep the company's know-how within the company's borders (e.g., restrictions on the use of employees' own devices) and the use of passwords and/or encryption, etc.



II. Investor Due Diligence

Once the parties have agreed on the key terms of the transaction – usually when a term sheet has been signed – the investor will undertake due diligence on the company, including legal, financial, market, commercial and tax. For these purposes, the investor and its advisers 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 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 investors will usually want to examine in their due diligence, although the scope and depth will depend on the stage of the company, as well as the size of the investment.⁶

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.

⁶ 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.

- 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;
- 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;
- Leasing agreements;
- Subsidies and other forms of state aids (including applications);
- Tax returns, statements and assessments; and
- Financial plans and budgets.

Intellectual Property Rights

- List and description of all patents, trademarks, copyrights, registered designs and other intellectual property rights (irrespective of being registered), know-how as well as domain names, which are used and/or owned/licensed by the company;
- Description of implemented protective measures regarding patents, trademarks, copyrights, designs and know-how;
- License agreements granting licenses or other rights to third parties, or which entitle third parties to use patents, trademarks, copyrights, registered designs and other intellectual property rights of the company;
- License agreements granting the company the right to use patents, trademarks, copyrights, registered designs and other intellectual property rights of third parties;
- Know-how agreements with third parties;
- Details of any employee inventions (*Arbeitnehmererfindungen*) and related documents;
- Agreements regarding other intangible rights (e.g., agreements about software utilization, web-hosting agreements and naming rights);
- Information as to whether the company (regardless if intentionally or unintentionally) failed to pay renewal fees in the past that are necessary to maintain the protection of any intellectual property rights (e.g., using a trademark);
- Disclosure of any documentation relating to any currently claimed or expected infringements of the company's intellectual property rights by third parties (or vice versa);

- 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.
- (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 advisers 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.

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;





A CLOSER LOOK:

The Increased Importance of European Data Privacy Regulations for Technology Companies

Given the ubiquity of electronic data, any sensible investor will seek a comprehensive understanding of the company's data privacy and cybersecurity risks. By nature, digital companies collect, process and transfer high volumes of data, and therefore bear a greater risk of violating data protection regulations. Such violation can constitute a major liability, in particular with the enactment of the European General Data Protection Regulation (*GDPR*) on May 25, 2018, as well as the *ePrivacy Regulation*. Under the *GDPR*, severe breaches of EU data privacy law are subject to potential fines of up to EUR 20,000,000 or 4% of (worldwide) turnover, whichever is greater. For investors, it is more important than ever to check if the target company complies – or can easily be equipped with frameworks to comply – with the relevant provisions, e.g., data breach policies privacy by design/by default and transfer of data, especially into non-EU member states, and rights of “data subjects” (i.e., customers/users whose data are collected and/or processed. These rights include the right to information, the right to data transferability and the right to deletion). In particular, if software does not comply with the principles of privacy by design/by default, such software can no longer be sold, purchased or used. If necessary, the investor will also assess the scope of changes to IT systems and business processes the *GDPR* may require, and reflect the findings in target's value, or at least some post-closing covenants to rectify any identified issues.

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 and internal regulations and standard exercises;
- 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;
- Noncompete/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).



III. The Legal Documents

In this part, we give a brief overview of the main legal documents that come up in the course of a 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 U.S. market, where well-established market standards exist, such standards for venture financing transactions are only emerging in the German market, though we have seen much development in this sector over the last couple of years.

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 certain aspects of the financing round and their (future) rights and obligations as shareholders in the company. The term sheet usually 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.

The term sheet is used as the basis for drafting the long-form investment documents summarized below. The more detailed the term sheet, the fewer number of issues which will need to be agreed upon during the drafting process of the legally binding documents. 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. 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. For this purpose, we have included a standard term sheet in Chapter D.

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."

2. Investment Agreement and Shareholders' Agreement

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 or to grant a shareholder loan, often convertible, to the company. 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*. These agreements also may be combined into one *investment and shareholders' agreement*.

- In the investment agreement, the parties set forth the terms and conditions for the 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 (for details, please see below in Chapter B).
- 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 (for details, please see below Chapter C).

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 uncommon in German start-ups). Rather, the decision about a financing round rests with 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 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).



Differences from U.S. and U.K. Investments: The Financing Round Agreements

U.S. 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 U.S. 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.

U.K. 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.

3. Ancillary Documents

The investment and shareholders' agreement often contains 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 potentially 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 investment and shareholders' agreement may be contained or repeated in the company's articles of association. 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 C.I.1, in light of some recent case law, it is also strongly recommended to include detailed provisions regarding the establishment, composition and role/powers of an advisory board in the articles of association (and not only in the investment and shareholders' agreement).

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

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, see Chapter C.I). 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.

Template Transfer Agreement

The investment and shareholders' agreement will often contain vesting provisions (for details, see Chapter C.V) that will apply if a founder leaves the company under certain circumstances. These provisions will provide that the founder will have to transfer her shares (or at least a part thereof) to the company, the investors or a third party nominated by the company or the investors. In order to avoid any legal uncertainty in case such a call-option is exercised, it might be advisable to attach a sample transfer agreement to the investment and shareholders' agreement that the parties are required to use for the share transfer.

Arbitration Agreement

Many investment and shareholders' agreements contain an arbitration clause (see Chapter C.VI.2). If natural persons will be bound by the arbitration clause, in particular the founders, it is advisable to have all parties enter into a separate arbitration agreement in addition to the investment and shareholders' agreement containing the arbitration clause.

B. The Investment Agreement



I. Pre- & Post-Money Valuation

Let's start by defining a couple of the most relevant economic terms that can be found in all investment agreements: "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 C.III.1). 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), 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 ($\text{EUR } 9,000,000 / 25,000 = \text{EUR } 360$). If the investor agrees to invest EUR 1,000,000, this will "buy" the investor $\text{EUR } 1,000,000 / \text{EUR } 360 = 2.778$ (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 $\text{EUR } 9,000,000 + \text{EUR } 1,000,000 = \text{EUR } 10,000,000$.



Differences From U.S. and U.K. 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 U.S. and the U.K., 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. Fully diluted usually includes (i) shares that have been issued by the company, (ii) shares allocated to the employee option pool (be it an equity-based or virtual share pool) and (iii) any other shares that the company could be required to issue through options, warrants, convertible debt or other commitments. A typical clause reads as follows:

The term “on a fully diluted basis” means the sum of [■(i)] the total number of Shares with a nominal amount of EUR 1.00 each assuming the exercise of any conversion right under any instrument (including any option agreements, convertible loan agreements, convertible promissory notes or the like) [■, and (ii) all Shares and any virtual shares with a notional value of EUR 1.00 as set forth in the [■V-ESOP/ESOP] (as defined below) issued or issuable to directors, employees, consultants or service providers or pursuant to a (virtual or non-virtual) stock option plan, restricted stock plan, or other stock or equity incentive plan].

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 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 below under Chapter C.VII.2), the economics stay the same.

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.

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 C.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.

II. Financial Contribution by the Investor

1. Forms of Financial Contributions and Milestones

Forms of Financial Contributions

In the investment agreement, the investor and those existing shareholders, if any, who participate in the financing round undertake to subscribe for the new shares, pay to the company the nominal amount of the new shares (*i.e.*, their par value) 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. The investor may also contribute an existing convertible loan into the company or undertake to provide certain services, including media services (so called *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. 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 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.

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 insolvency of the company, its insolvency administrator could still request fulfillment of the respective contributions.

Milestones

Sometimes 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 to waive their milestones, or to adjust them mid-course, if both investors 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."

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

- The investor can immediately receive as many shares as is applicable when it 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 its shareholding and receive more and more (preference) rights as set forth in the shareholders' agreement.

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 financing round new shares. 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. When there are no closing conditions in the investment agreement, such shareholders' resolution may already be included in the notarized investment agreement.

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 preemption rights. Otherwise, the existing shareholders usually undertake to waive their (statutory or contractual) subscription rights.

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 about proper payment of the nominal capital of 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 registration of the financing round capital increase is reflected in the commercial register of the company.

The Financing Round New Shares

A venture capital investor 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 we will see, these preference rights usually fall into two categories: financial rights and control rights. Venture capital investors 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) and at a much higher valuation. The venture capital investors will also have less control over the company's day-to-day operations than the founders, who typically remain closely involved in management.

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. Thus, if a preferred share class already exists at the time of an investment round, the new round of investors will typically create a new series of preferred shares to distinguish the rights that attach to their preferred series from those that attach to all prior series of shares, e.g., if seed investors have subscribed for series seed preferred shares, the series A investor will subscribe for series A preferred shares.⁷

These preferences can be set forth only in the investment and shareholders' agreement, which has the benefit of maintaining confidentiality from the general public. It is, however, often advisable to also set forth these rights in the company's articles of association. The latter is particularly true for special dividend rights, liquidation preferences, special drag-along rights and/or rights to appoint and remove members of the advisory board (if established.) A typical clause in the company's articles of association would then read as follows:

⁷ The letter designating a financing round is incremented in each subsequent round (Series B, Series C, etc.). Occasionally, a number is added to the letter for subsequent rounds, e.g., a Series B1 follows the Series B financing round. The main reason for this is to limit how far into the alphabet the company goes, particularly because the general expectation is that with each new letter, the valuation of the company should go up as well. If, for example, after raising a EUR 5 million Series A financing round at a pre-money valuation of EUR 50 million, the company agrees to accept another EUR 2 million as a follow-on investment from a new investor at more or less the same valuation within a reasonable period of time after the financing round has closed, it makes sense to label this second closing a Series A1 financing.

1. The Company's share capital amounts to: EUR [] (in words: Euro []).
2. The share capital is divided in:
 - a) [] common shares ("Common Shares") each in the nominal value of EUR 1.00 with serial nos. [] through [];
 - b) [] preference class seed shares ("Seed Shares") each in the nominal amount of EUR 1.00 with serial nos. [] through [];
 - and
 - c) [] preference class series A shares ("Series A Shares") each in the nominal amount of EUR 1.00 with serial nos. [] through [].
3. Seed Shares and Series A Shares (together "Preferred Shares") shall grant the preference rights specified in these Articles of Association and in relevant shareholders' agreements between the Company's shareholders (if any). Apart from that, any and all shares of the Company, including the Preferred Shares, shall be vested with the same rights and obligations. In particular, the division of the shares into different classes according to the above shall not constitute any requirement for special shareholder resolutions. The revocation or amendment of the preferred rights of a Preferred Share shall be subject to the consent of the holder of such Preferred Share ("Preferred Shareholder").
4. Each Preferred Shareholder has the right to convert all or part of his Preference Shares into Common Shares at any time at a conversion rate of 1:1. In such event the Company shall take all actions necessary to effect the conversion.



A CLOSER LOOK:

Merger Clearance Requirements for Venture Capital Investments

Some venture capital investments may be subject to merger control. In such cases, the transaction will need to be reported to and cleared by the competent competition authority (or authorities) before it may be implemented. Whether or not a merger filing is required usually depends on two questions:

- Does the investment constitute a “concentration” within the meaning of the merger control rules?
- What is the “turnover” (revenues) of the undertakings participating in the concentration?

On the first question, a transaction usually qualifies as a concentration under German law if a share of 25% or more of the equity or the voting rights in a company is being acquired. Below this threshold, an investment in another company may constitute a concentration if it confers “control” or a “competitively significant influence” upon the acquirer. This may be the case, for example, if the acquirer obtains certain veto rights or has the power to appoint representatives to the executive or supervisory boards of the start-up.

Regarding the second question, a filing is required if the “undertakings concerned” meet the statutory turnover thresholds. For German merger control, these are:

- EUR 500,000,000 worldwide in relation to all parties concerned;
- EUR 25,000,000 in Germany in relation to one party; and
- EUR 5,000,000 in Germany in relation to another party.

Where the first two thresholds are met, but not the third, in particular: where the target’s turnover in Germany is less than EUR 5,000,000, German merger control will still apply if (i) the value of the consideration is more than EUR 400,000,000 and (ii) the target has significant activities in Germany. The value of the consideration includes all assets and other noncash benefits received by the seller from the buyer in connection with the concentration as well as the value of any liabilities assumed by the buyer. This value-based threshold was introduced into the law in mid-2017 to capture transactions, particularly in the internet space, where a start-up’s turnover is less than EUR 5,000,000.

The term “undertaking” includes all entities and persons under common control, *i.e.*, the entire group of companies to which a company involved in the transaction belongs. When considering, for instance, whether the acquirer meets the turnover thresholds, it is not sufficient to look at the acquiring entity only; rather, the consolidated turnover of the acquirer’s group of companies needs to be taken into account, even if some or all of the market activities of the acquirer’s group have no competitive significance for the transaction. In addition, the undertakings concerned are not only the CVC investor and the start-up (and their affiliates) but also other shareholders that hold 25% or more of the shares in the target or that control the target (alone or jointly with other parties).

Determining whether or not a transaction needs to be filed with the German Federal Cartel Office (*Bundeskartellamt*), therefore, requires a careful analysis of the transaction structure and the corporate governance of the start-up as well as information on the revenues generated by the parties participating in the concentration. This becomes even more important when the activities of the start-up are not limited to Germany. In addition to German merger control, the relevant rules in other jurisdictions need to be considered.

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' agreement and potentially other costs for outside advisers.

Use of Funds

Investment agreements may 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 new investors. 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.



III. Representations, Warranties, and Remedies

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

Venture capital investors will expect appropriate representations and warranties to be provided by the founders and the company, as well as the existing key investors, though the latter usually only to a limited extent and/or only subject to knowledge qualifiers. 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 past history so that the investor can make an informed decision about whether it wants to invest.



Venture financings are not just small-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 might not be appropriate for a venture capital financing. 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 arena), they tend to be less relevant 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 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, as in the next financing round, the 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 certain 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 out in 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 venture capital investors initiate court or arbitral 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 venture capital investors in Germany so far. Our guess is that if venture capital investors 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 when, in many cases, all relevant assets are only shares in the target company 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.

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 on company shares;
- No other shareholders' agreement and trust 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' agreement or the articles.

Financials and Business Plan

- Preparation of financial statements in accordance with German GAAP;
- No off-balance sheet liabilities and no credit liabilities;
- The diligent preparation of the business plan presented to the investor, if any; and
- Management accounts, if any.

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.

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 noncompete restrictions; and
- No termination of material agreements and no violation of terms of material agreements.

Employment Matters

- Complete list of all employees;
- 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

- Real estate and assets;
- Insurance situation and history of the company;
- Fair (and complete) disclosure of information in the investor's due diligence; and
- Product safety and warranty obligations.

3. Remedies

The investor expects the guarantors (*i.e.*, in most cases the company and the founders) 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 refer to sects. 249 *et seq.* German Civil Code in the investment agreement for the consequences of a breach of a representation and warranty. 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, at least in later-stage financings, there are usually 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.



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 basket of 1.0%;**
- **Survival period of 18 months for operational and 3 years for more fundamental representations; and**
- **Cap for operational representations that takes into account the founders' financial means (e.g., multiple of annual income).**

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 this section of the investment agreement 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. 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 it is market standard to exclude lost profits and prevent the investor 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.

An example for a loss definition may read as follows:

“Losses” shall

Include all actual direct damages (unmittelbare tatsächliche Schäden), any reasonably and reasonably adequately caused damages (typischerweise adäquate-kausale Folgeschäden) and related reasonable legal expenses (angemessene Rechtsverfolgungskosten) [■or alternatively: all actual direct damages (unmittelbare tatsächliche Schäden) and only those consequential damages (Folgeschäden) as well as indirect damages (mittelbare Schäden) that are reasonably foreseeable or typically expected to be encompassed by the purpose and intent (vertragstypischer Zweck) of the respective Guarantee, covenant or obligation];

But otherwise

Exclude any (i) lost profits (entgangener Gewinn), (ii) other indirect and consequential damages, (iii) internal administration and overhead costs, (iv) any frustrated expenses (vergebliche Aufwendungen) pursuant to sec. 284 German Civil Code, (v) any damages/losses to good will, (vi) any damages based on the allegation that the investment made by the investor in the course of the financing round has been calculated or determined based on incorrect assumptions (e.g., earnings or other multipliers), and (vii) damages for lost opportunities (entgangene Geschäftschancen).”

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 disclosed to the investor in the disclosure schedule attached to the investment agreement or documents provided in the data room;
- 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 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 there is not really a market standard in Germany for caps on founders’ liabilities, we think that in many cases it makes sense to cap their liability at an amount of twice their annual gross salary. We arrive at this number because it is still a significant risk that should motivate the founders to make proper disclosures, but it is not overly excessive.

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 often 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.

Form of Compensation

Besides a compensation in cash, there are various alternatives that the parties should contemplate:

- The investor could be compensated in equity rather than in cash. This 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. Alternatively, the founders could be obliged to transfer against payment of their nominal value a corresponding number of their shares to the investor. The investment agreement should then foresee that upon transfer these common shares shall become series preferred shares;
- Rather than a cash payment from the company, the investor could receive an (interest-bearing) preferred claim on dividends or liquidation proceeds senior to any other preference rights.

C ● **The Shareholders' Agreement**



Differences from U.S. and U.K. 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 U.S. and U.K. 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 German 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 U.K. and U.S. have moved closer to a *de facto* two-tier system. We see this in the growing importance of nonexecutive, outside and independent directors in U.K. and U.S. 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 U.S. or U.K. board of directors becomes more similar to a typical German market advisory board, though German market advisory boards tend to have less power than U.S. or U.K. boards.

I. Corporate Governance – Overview

The corporate governance of venture capital-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, which supervises and advises the management board.

While the shareholders' meeting is a mandatory corporate body, neither a GmbH nor an UG (haftungsbeschränkt) need to have an advisory board (see below for cases where a mandatory *supervisory 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 reserving approval of more material fundamental and strategic matters for the shareholders' meeting.

- The shareholders are responsible for deciding upon certain more structural matters, such as capital increases, changing the form of the company, amending the articles of association or establishing employee participation programs. As we will see, it is a common feature in venture capital-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.
- The advisory board can be controlled by the investors, in particular after a couple of financing rounds, but not necessarily. In a non-investor-controlled board, it is not uncommon to give the investor members of the advisory board certain special veto rights to approve material business decisions.

1. 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.

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 powers in the company's articles of association. This is because some recent, though ambiguous case law suggests that it no longer suffices to have these rules only set forth in the investment and shareholders' agreement in order to be valid and enforceable. Depending on the powers that the advisory board is given, it might also be advisable to file a list of the members of the advisory board with the commercial register of the company and keep that list updated in case of any changes in the composition of the advisory board. In particular, if the advisory board is permitted to appoint and remove the managing directors of the company, then if a list of advisory board members is filed with the commercial register the commercial register, can relatively easily assess the effectiveness of any such appointment or removal resolutions.

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 (in a nutshell, more than 500 employees) and for all German joint stock corporations irrespective of size, and it can also be established by other corporations on a voluntary basis. However, 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 Corporation Act (*AktG*) and the German Act on Limited Liability Companies (*GmbHG*) 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 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 angel investors), are granted a right to appoint and revoke a member to the advisory board. Despite having few members, the composition of an advisory board often reflects the "balance of power" of the shareholders among each other. Power can be reflected in the number of members a shareholder or group of shareholders can appoint or whether certain advisory board members have veto rights (at least for certain matters.)

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.

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 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. Usually, the board can also bring in special authorized experts with such an inspection at the company's costs.

In German start-ups, advisory board members are usually compensated for travel and out-of-pocket expenses, while a remuneration

is rather uncommon, with the exception of external advisory board members who (rarely) may receive a small cash remuneration or be allocated (virtual) shares under an employee stock option plan (for details of such plans, see below under Chapter C.VII.2). Sometimes external advisory board members are invited to invest money in the company alongside the venture capital investor.

2. 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 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 while individual investors usually hold less than 50% of the company, they do 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 small percentage in the company after a couple of financing rounds, consent rights are usually reserved for the largest investors only. Another more flexible and dynamic 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. 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. 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. 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.

II. Information and Monitoring Rights

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. Here is an example of a typical information right:

1. Each shareholder shall have all statutory information and inspection rights vis-à-vis the company.

2. In addition, the company shall furnish the following information within the relevant prescribed time periods to each shareholder [in form and substance consistent with past practice]:

2.1 Within [] Business Days following the expiration of each fiscal year: unaudited financial statements including balance sheet data of the respective fiscal year;

2.2 Within [] Business Days following the expiration of each fiscal year: audited annual financial statements including balance sheet data of the respective fiscal year, provided the financial statements have to be audited according to applicable law;

2.3 [for more mature companies: Within [] Business Days following the expiration of each calendar month and each quarter of a fiscal year: unaudited monthly and/or quarterly financial statements of the company, including: (i) profit-and-loss statement, (ii) cash flow statement, (iii) staff planning, (iv) a roll-over liquidity plan and a general forecast for the following 12 months; and (v) a management report covering all major events).]

2.4 [as the case may be: Within [] Business Days following the expiration of each calendar month: monthly investor briefings covering the most relevant areas in the overall business progress, including information on matters of strategy, science, product development, business and corporate development, human resources and including key financials, certain key performance indicators and a deviation analysis (Abweichungsanalyse) against the current business plan in a form as prepared by the company or as reasonably requested by an Investor Majority; and]

2.5 Without undue delay after they become available: copies of the signed minutes of advisory board's meeting and advisory board's resolutions.

3. The board of directors shall promptly keep the shareholders informed of any material developments affecting the company and its business operations.

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.

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.



Differences From U.S. and U.K. Investments: Shareholder Information Rights

While in U.S. & U.K. 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 noncompete 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.

2. Inspection and Audit Rights

In addition to and supplementing the shareholders' information rights, the shareholders can often inspect all books and records (electronic and/or hard copy) of the company and are allowed to make copies during normal business hours. Shareholders can also be given the right to request an audit of such records by an independent accountant of its choice or, in some cases of corporate venture capital investors, by representatives of such shareholder and its affiliates' own internal corporate audit functions. There is a theoretical risk that a shareholder might misuse this right

to materially negatively affect the day-to-day operations of the company. To address this risk, this audit right can be made subject to the occurrence of facts or circumstances which give reason to suspect that improprieties or material breaches of applicable law, the investment and shareholders' agreement or the company's articles have occurred.

3. Management Rights Letters for U.S. Investors - ERISA Compliance

In U.S. financings, it is typical for a U.S. venture fund investor to require, as a condition of its investment, a *management rights letter* with the company issuing the securities. As we will see, U.S. venture fund investors might frequently also request such a management rights letter when investing in a German tech company. A management rights letter is form-based and provides certain information and inspection rights should the U.S. venture fund investor not have a seat at the company's board of directors.

The reason why a U.S. venture fund investor may require such management rights letter is if a pension plan covered by the U.S. Employee Retirement Income Security Act of 1974, or simply ERISA (an "ERISA Plan") invests in such U.S. 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 U.S. venture fund is treated as an ERISA fiduciary and such fund must comply with the rules regarding prohibited transactions.

However, the U.S. Department of Labor, which is charged with administering ERISA rules, has issued regulations that contain certain exemptions from the ERISA Plan asset rules. A U.S. 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 U.S. venture fund will generally ask each of its portfolio companies, including German companies, to sign a management rights letter in connection with its investment.



III. Financial Protection of the Investor

1. Antidilution

Rationale for Antidilution Protection

Investors often require antidilution protection rights. 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. 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.

This protection usually works by applying a mathematical formula to calculate a number of additional shares that 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 (through the mechanisms of virtual employee participation plans), the managers and key employees of the company. 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 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.
- 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 U.S. Investments: Implementation of an Antidilution Protection

While both German and U.S. market antidilution provisions, if triggered, result in the investor acquiring additional shares in the Company, most U.S. 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 U.S. 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 U.S. 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.

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 U.S. venture capital deals, the conversion price for which preferred shares can be converted by the investor into common shares is ratcheted down.

This is the most investor-friendly option and has a real impact on the holders of common shares. Although in the current German market, we would consider the full ratchet antidilution to be the exception rather than the rule, we notice that it is still used in sectors where venture capital is particularly scarce, *e.g.*, biotech.

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 the problems of an otherwise already difficult financing.

Weighted Average

There are more balanced approaches to antidilution that provide some compensation for the dilution but allow the ownership percentage of the investor to decrease. One of these is the *weighted average* formula, which we see frequently today.

The weighted average formula adjusts the number of shares of an investor protected by the antidilution provision based on the issuance price and 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 based on the weighted average of all shares (common and preferred) plus outstanding options and warrants and (as we have seen on various occasions) virtual shares. 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 usually disregards the outstanding options, warrants and virtual shares (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.

Here is an example for a (simplified) formula to determine the number of new shares to be issued to the investor entitled to a weighted average antidilution protection:

The total number of dilution protection shares to be offered to the Investor under the antidilution protection shall be calculated as follows:

$$D = ((p1 - 1) / (W - 1)) \times n1 - n1, \text{ with}$$

D = total number of dilution protection shares to be issued to the investor;

p1 = the share price originally paid by the investor (as adjusted from time to time);

n1 = total number of preferred shares held by the investor entitled to the antidilution protection prior to the down round and the antidilution capital increase; and

$$W = ((p1 \times n1) + (p2 \times n2)) / (n1 + n2), \text{ with}$$

W = the weighted average share price;

p2 = the share price of the down round;

n2 = total number of shares issued in the down round (not taking into account the dilution protection shares issued in the antidilution capital increase.)

If all holders of preferred shares based on their respective subscription prices will benefit from an antidilution, you can see how the situation can get complex. Here, it is often advisable to attach sample calculations to the investment and shareholders' agreement for information purposes. Also keep in mind that if a financing round-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.

Other Considerations

If properly drafted, antidilution provisions will also contain a number of carve-outs, which are certain kinds of events that do not trigger the antidilution. Standard exemptions include the issuance of shares within the framework of an equity-based employee participation program or in the course of a compensatory capital increase in case of a warranty breach (for details, see above under Chapter B.III.3) and for consideration other than cash pursuant to a share swap (*Tausch*), contribution of shares (*Einbringung*), merger (*Verschmelzung*) or other transformation within the meaning of the German Law on Transformations of Companies (*Umwandlungsgesetz*.) 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.

Contingency and Expiration of Antidilution Protection

As we have seen, antidilution provisions can have material economic impacts. There are several ways to soften these impacts. 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.** As already described in detail above (see Chapter A.I.3), the investment and shareholders' agreement can require an existing investor to participate in the down round (pay) in order to benefit from the antidilution protection (keep playing.)
- **Expiration With the Next Financing Round.** The investment and shareholders' agreement can state that the antidilution protection shall automatically expire after the next financing round, provided that such financing round is not a down round. The rationale behind this mechanism is that the antidilution clause should only provide a downside protection. 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 — have agreed on a too high price. Once the price is validated there is no need for further protection as the antidilution clause is not intended to permanently reallocate the risk of any future development of the company to the founders.
- **Time Limitations.** Based on similar arguments, the antidilution protection can also lapse after a certain period of time, e.g., two years following the financing round (irrespective of whether or not, and how many, financing rounds might occur during that period of time).

2. Preference Dividends

A common feature of U.S. and U.K. venture capital investments is *preferred dividend rights*. 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: Venture capital investors 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, venture capital investors 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 *prorata* share of any dividends paid to the holders of common shares on top of their preference right.

Below is a sample wording for a typical preference dividend right. To avoid tax issues,

such special dividend rights should be set forth in the company's articles of association.

The Preferred Shares grant the Preferred Shareholder the following preference rights:

1. If and to the extent it is resolved that the profits of the Company shall be distributed, the Preferred Shareholders shall receive profits in preference to all other shareholders (the "Preference Dividend.") i.e., the amount equal to [■]% per annum of the respective amount, which the Preferred Shareholders have paid when subscribing for the respective Preferred Shares (including the nominal payments and payments into the capital reserves of the Company in accordance with sec. 272 para. (2) no. 4 German Commercial Code – the sum of these amounts paid is the "Preference Amount") per Preferred Share with a nominal amount of EUR [■] to be allocated among the Preferred Shareholders prorata to their holding of Preferred Shares inter se, unless the amount must not be distributed among the shareholders due to statutory law.

2. If the distributable profits of the Company are not sufficient to pay the full Preference Dividend on every Preferred Share, the respective amounts shall be distributed to the Preferred Shareholders prorata to their maximum entitlements. (Partially) unpaid Preference Dividends shall accrue and increase the entitlement to a respective Preference Dividend of the Preferred Shareholders in the following year(s.)

3. Provided that and to the extent that the shareholders resolve to distribute the profits remaining after full payment of the Preference Dividend, and provided there are no overriding shareholders' agreements, such profits shall be distributed among all shareholders [■ as the case may be: (including Preferred Shareholders)] prorata to their shareholdings (by nominal amounts) inter se.

3. Liquidation Preferences

A common feature of venture capital 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 before holders of common shares. This preference amount may be equal to the amount of the preferred shareholders' investment 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 returns at exit.

Brad Feld and Jason Mendelson, in their insightful book *Venture Deals: Be Smarter Than Your Lawyer and Venture Capitalist*, 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.

Consider, for example, the following language:

Upon the occurrence of an Exit (as defined below), or a dissolution or liquidation of the Company (each a "Liquidity Event"), each holder of [■Preferred Shares/Investor] shall be entitled to a [■1] x [(nonparticipating)] liquidation preference (einfache anrechenbare Liquidationspräferenz)

("Liquidation Preference") with regard to all proceeds in connection with such Liquidity Event, including any cash or non-cash sales proceeds, dividends, liquidation or redemption proceeds after deduction of any Transaction Costs (as defined below), ("Liquidation Proceeds") in accordance with the following provisions: [■]

There are three key features that make up a liquidation preference:

- When does it apply?
- What is the amount of the preference?
- 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 the example above, you'll see that 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 C.IV.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 if an owner who has already received a liquidation preference

should benefit 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*.) The multiple is an indicator of market and sector dynamics. Today, in the venture capital market in Germany, we would consider a 1x liquidation preference to be standard. As a compromise, we sometimes see a 1x liquidation preference with computational interest, often 6% or 8% p.a.

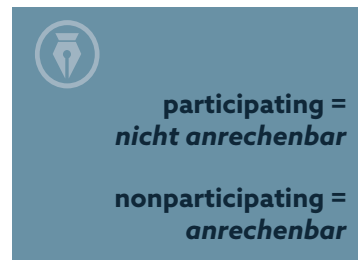
Contrast this with the 3x and higher liquidation preferences we saw after the burst of the internet bubble in the early 2000s or – to a lesser extent – after the onset of the Global Financial Crisis in 2007/2008. The liquidation preferences went up when venture capital became increasingly scarce and venture capital investors had more leverage.

Irrespective of whether the liquidation preference is structured as a fully or capped participating or nonparticipating 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. This amount that needs to be returned to investors to satisfy all liquidation preferences is sometimes referred to as *liquidation preference overhang*.

Participating vs. Nonparticipating 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 *nonparticipating* 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).

- The most founder-friendly option is the nonparticipating liquidation preference (*anrechenbarer Liquidationsvorzug*). 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 *prorata* basis among all shareholders.



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

- More investor friendly 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 ordinary shareholders, *i.e.*, without a catch-up. U.S. investors call this participation an “as-converted” basis, which means that with respect to the distribution of liquidation proceeds, the preferred shares are treated as common shares based on the conversion ratio (initially usually 1:1).
- Capped participations indicate that the preferred stocks 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 their investment.

Layers of Liquidation 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.** The simplest approach is to treat the various preferred shares as *pari passu* so that 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 invested in the company in the series A and the series B.
- **Stacked Liquidation Preferences.** 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 series B preferred shares receive their entire liquidation preference before the series A preferred shares receive any liquidation preferences.

When negotiating liquidation preferences investors should keep in mind that they might demotivate the founders, as holders of common shares, and also other employees. As we will see, in the German market, employees will usually not be granted “real” options under an equity-based employee participation program but will rather get virtual shares. These virtual shares are often designed to mirror the economic outcome of a holder of common shares in a liquidation event. Because of this possibility, rational investors will seek a balance between juicing up the value of their investment and maximizing the motivation of the founders and the employees of their company. We like how *Eric Ries* summarized this in his most recent book *The Startup Way*: “Startup equity is a complex financial derivative that powers the entire venture-startup-ecosystem. It’s not profit sharing, it’s not a union but it is the greatest tool of employee empowerment I have ever seen.”

4. Other Protective Covenants

The investment and 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:

IP-Related Covenants

Above (see Chapter A.I.4), 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 include:

- 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 (*übertragen das ausschließliche Nutzungsrecht*) to use such (current or future) IP rights.

- The company and the founders shall use 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.

Key Man Insurance

Sometimes – though this is still a less common feature in German venture capital deals – the investor may require the company to take out *key man insurance* coverage. A key man insurance is an insurance policy obtained by the company on the lives of its key managers and/or employees, usually the chief executive officer and the person or persons ultimately responsible for continuing to develop the technology.

Measures Against Sexual Harassment and Discrimination

Lately, we have seen that VC investors in the U.S. pay closer attention to the issues of sexual harassment, discrimination and lack of diversity in their investment decisions. Although this is still an ongoing development, we have come across term sheets with covenants requiring the target company to adopt anti-harassment and anti-discrimination policies within a short period after closing and to ensure that all employees are well informed and aware of such policies. Other investors have announced zero tolerance policies and conducted comprehensive investigations of any allegation of misconduct in any of their portfolio companies.

Although in Germany the issues of equality in the workplace may not be as apparent as in the U.S., they are not unique to the U.S. venture capital sector.⁸ We expect these matters to play an increasing role in the German market over the coming years as well. While some investors already include the adherence to anti-discrimination laws in their general compliance requirements, we expect more specific requirements and more emphasis on inclusion and diversity in the due diligence process.

⁸ For example, the 2017 edition of the German Startup Monitor found that in Germany, female founders make up only a disappointing 14.6% of the cohort (although this is still a slight increase over the previous years). See http://deutscherstartupmonitor.de/fileadmin/dsm/dsm-17/daten/dsm_2017.pdf.



IV. Share Transfers and Exit

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 nearly all GmbHs in Germany provide for restrictions regarding the transferability of shares (*Vinkulierung*), usually requiring the consent of the shareholders' meeting for a share transfer. In the investment and shareholders' meeting, the parties then agree in which cases they shall be obliged to vote their shares in favor of a

transfer. Such cases generally include a group of permitted transfers 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 C.IV. 2 and 3).

For shareholders other than the founders, customarily such permitted transfers include transfers to an affiliate of the shareholder effecting the transfer, provided that the shareholder effecting the transfer ensures that the affiliate shall be bound by the investment and shareholders' agreement in the same way as the shareholder and that the shareholder shall continue to be liable for the obligations under the investment and shareholders' agreement as joint and several debtor. If the shareholder is an institutional venture capital investor, generally permitted transfers also include transfers to another venture capital fund that is controlled by or under common control with one or more general partners or managing members of, or shares the same management company with, such investor effecting the transfer.

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 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 closing date (usually three to five years.) Such period often, though not necessarily, corresponds to the vesting periods applicable for the founders (see under Chapter C.V). 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 may be 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.

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, it 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 its co-shareholders without the need to already have obtained a third-party offer. The selling shareholder may accept or reject, in its 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 its 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 its 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 advisers.

3. Drag-Along and Tag-Along

Drag-Along

A *drag-along* (also 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 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 *prorata* portion of their shares to such third party. Sometimes, especially in early rounds, drag-along rights can only be enforced with the consent of an investor majority.

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 German GmbH (for a German joint 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 investment and 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.
- Despite the previous paragraph, an acquirer may still insist on broader representations and warranties from all shareholders and the investors might still find the transaction to be economically appealing. In this instance, the investment and shareholders’ agreement should allow an investor majority to waive the aforesaid exemption from the drag-along right so that even dragged investors have to give representations and warranties upon the same terms and conditions as the other shareholders.

- Individual shareholders that only hold a small stake in the company and who might only benefit at the lowest level of the waterfall when it comes to the distribution of exit proceeds should also be aware that many acquisition agreements will contain a two- to three-year noncompete undertaking for the sellers. 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 noncompete undertakings.

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 *prorata* 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. 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 is a matter of negotiation.

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 venture capital investors 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 for which the investment and shareholders' agreement provide, 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 investment and shareholders' agreement usually contains a number of provisions about what is considered an exit event and how the exit process will work.

Here is a typical definition of an exit event and the underlying exit process:

"Exit" means any of the following:

a) A sale, exchange, contribution or other transfer of at least [■50%] of the company's outstanding share capital to one or more third parties, whether in one transaction, in a series of connected transactions or in a series of transactions with a close temporal relation;

b) The sale, transfer (including the transfer of beneficial or economic ownership), exclusive licensing or other disposition of

all or substantially all of the company's assets that collectively amount to more than [■50%] of the market value of all of the company's assets to one or more third parties, whether in one transaction, or in a series of connected transactions or in a series of transactions with a close temporal relation; and

c) Any form of consolidation, merger or any other form of transformation (except for a mere transformation of legal form, which does not entail changes in the shareholder structure of the company) with a third party, irrespective of the applicable law regime, provided that upon consummation of such consolidation, merger or other form of transformation, the relevant shareholders together possess [■50%] or less of the outstanding shares, equity rights or voting power of the relevant surviving entity;

(the underlying process is hereinafter referred to as an "Exit Process.")

General provisions around the exit process often deal with who can initiate the exit process, how outside counsel and M&A advisers 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.

5. IPO-Related Provisions

In the U.S., 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.

A discussion about the various advantages and disadvantages of an IPO for the success of a start-up is beyond the scope of this Guide. We do want to mention, however, that the window for technology IPOs in Germany has not been particularly wide open over the last couple of years. Since 2015, only a few tech start-ups attempted an IPO in Germany, and results for

investors were mixed. It remains to be seen if some of the (at least initially) more successful IPOs in 2017 will have a positive impact on the IPO environment and pave the way for other start-ups and their investors.

If so few technology companies in Germany will go public, one might wonder why bother including IPO-related provisions in the investment and 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) investment and 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 limited liability company into a joint stock corporation under German law (*Aktiengesellschaft*) or a *Societas Europaea*, i.e., 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 investment and 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 joint stock corporation.
- As an alternative to a transformation of the company itself and its subsequent listing, the investment and shareholders' agreement may also provide for the option of a flip into a U.S. legal form, usually a Delaware corporation, in order to enable a public listing at a U.S. stock exchange. A *flip* refers to the "transfer" of a German start-up to a U.S. legal structure. In this process, the shareholders "swap" or "flip" their shares in the business-carrying German company for shares in a U.S. company. As a result, between the founders and investors of the German company, a new U.S. parent company is established which can then be floated. As a flip will usually be a taxable event, the investment and 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.⁹

⁹ For details about a typical German/U.S. flip and its tax consequences, see our special guide *Go West: Venture Financings and Expansion Projects in the United States - Practical Guidelines for German Technology Companies*, Orrick, Herrington & Sutcliffe, July 2017, available at: <https://www.orrick.com/Insights/2017/07/Go-West-Venture-Financings-and-Expansion-Projects-in-the-United-States>.

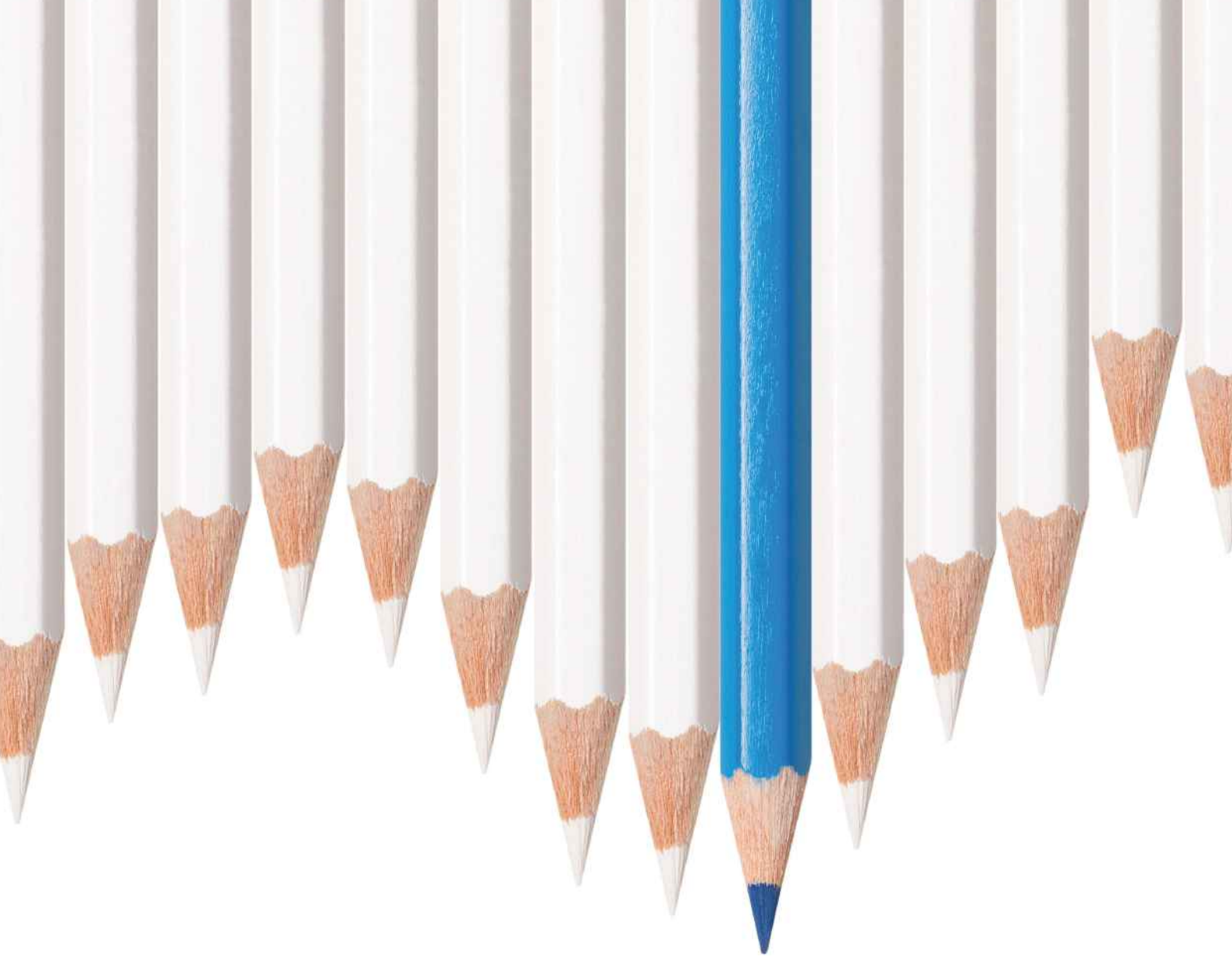
- All shareholders are usually subject to rather broad cooperation obligations. This may include the obligation that all shareholders will fully cooperate with each other, provide all requested consents and take all requested measures to execute the IPO. Other steps to be taken may include the conversion 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. As an IPO is often an expensive undertaking, it is advisable to also agree in the investment and shareholders' agreement what costs shall be borne by the company.
- Finally, the investment and shareholders' agreement may also include some special provisions for listings on a U.S. stock exchange that larger U.S. 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).



Differences From U.S. Investments: Registration Rights

Under U.S. 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 U.S. is not required to register all of its outstanding shares, investors in the U.S. or in German technology companies which may, following a flip, consider pursuing a listing in the U.S. 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 U.S. 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).





V. Founder Vesting and Leaver Events

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. 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.

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 himself 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.

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.



VI. Dispute Settlement

1. Resolution of Specific Business Disputes by Expert Determination

Most disputes relate to specific factual questions, often about how calculations should take place. For instance, we've seen disputes about the amount of the "Reduced Valuation" in the event there is a compensatory capital increase to remedy a breach of a company's representations and warranties (see above Chapter B.III.3). We've also seen disputes over the computation of the compensation amount following a redemption of shares. In these cases, 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 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 shareholders' agreement, 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.

A typical clause may read as follows:

If the Parties cannot agree on the reduced valuation within ten business days after the investor has submitted its calculation of the reduced valuation, then the reduced valuation shall be determined by an independent third party, which shall act as an expert (Schiedsgutachter) within the meaning of sec. 307 et seq. German Civil code and not as an arbitrator, (Schiedsrichter) in accordance with the following provisions:

a) If the involved parties cannot agree on an independent expert within five business days, the independent expert shall be appointed by the chairperson of the "Institute of Public Auditors in Germany" based in Düsseldorf (such agreed or appointed independent expert hereinafter the "Expert").

b) The Expert shall adhere to any mutual agreement between the involved parties regarding the determination of the reduced valuation.

c) The Expert shall be instructed to submit its decision in writing in the English language within 20 business days after its appointment (or as soon thereafter as it is able to do so).

d) Each of the involved parties shall be entitled to make written representations and cross-representations to the Expert in the English language, copies of which shall be sent by the respective party to the other included parties without undue delay.

e) The decision by the Expert shall be final and binding according to sec. 319 German Civil Code. Any disputes regarding the questions if and to what extent the Expert's decision is binding shall be decided in accordance with the provisions set forth in [reference to arbitration clause or jurisdiction].

f) The Expert shall be authorized to clarify preliminary legal questions (rechtliche Vorfragen) in relation to and within the scope of its assignment, including the interpretation of this agreement.

g) The Expert shall also decide on the distribution of its costs (including the costs already paid by one Party in advance) in accordance with sects. 91 et seq. German Code of Civil Procedures (Zivilprozessordnung).

h) The parties shall provide the Expert with all information and support reasonably required.



A CLOSER LOOK:

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.¹⁰ 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 the company exercises a call-option in case of a founder leaver event. Here, simply stating in the articles or the investment and shareholders' agreement 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. 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."

A number of specific start-up valuation methods have been suggested over time, including the *Harvard Venture Capital Method* from the 1980s. This method forecasts a future (exit) value (e.g., five years from the present) and discounts that terminal value back to the present by applying a high discount rate. The valuation of the company at the expected future (exit) date is based on factors such as a multiple of sales or earnings.

In some cases, it might be an easier and more practicable way to have a clause in the shareholders' agreement 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 investment and 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 to six months), then the valuation of this financing round shall be decisive for the determination of the fair market value of the company and any compensation already paid to the departing shareholder would be retroactively adjusted.

¹⁰ One of the authors of this Guide (Sven) still believes that it also has something to do with last weekend's soccer results, which would make him, as a diehard supporter of Hamburger SV, probably a pretty grumpy and pessimistic investor.

2. General Dispute Settlement and Arbitration Clause

The investment and shareholders' agreement 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 carefully consider when drafting the investment and shareholders' agreement.

Unfortunately, we see a widespread sloppiness when it comes to drafting adequate dispute resolution clauses. Optimally, the parties should think in scenarios and try to anticipate the most likely types of disputes that may arise and draft the dispute resolution clause accordingly. Arbitration generally offers 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 U.S. 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.

If individuals are supposed to sign an arbitration clause, it is highly advisable to have all parties enter into a separate arbitration agreement (setting forth the details for the arbitration proceedings) rather than just having an arbitration clause alone in the investment and shareholders' agreement.

Here is a standard wording for an arbitration clause:

The Parties expressly agree that any disputes arising out of or in connection with this Agreement shall be finally settled in accordance with the Arbitration Rules of the German Institution of Arbitration (Deutsches Institut für Schiedsgerichtsbarkeit - DIS) without recourse to the ordinary courts of law. The place of arbitration shall be [], Germany. The language of the arbitral proceedings shall be the [English] language. The provision of evidence made in the [English or German] language is permitted. The Parties will enter into a separate arbitration agreement attached hereto as Annex. Former Parties shall remain bound by this arbitration clause.

If and to the extent to which recourse to the ordinary courts is still possible (despite the arbitration clause), the courts of [], Germany, shall, to the extent permissible under applicable law, have exclusive jurisdiction.





VII. Other Relevant Provisions

1. 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 Zugewinnngemeinschaft*) which applies by default unless agreed otherwise by prenuptial agreement (*Ehevertrag*). Under the regime of community of accrued gains, each spouse generally manages his/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 his or 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 his or 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 his or 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 his or 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 his or 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.

Against this background, founders should be aware that many investors will request to include covenants in the investment and shareholders' agreement such as the following:

1. In case a Shareholder marries or is already married, he is obliged to enter into a prenuptial agreement (Ehevertrag) with his spouse to procure the following:

a) In case a Shareholder is not married under the community property regime (Zugewinnngemeinschaft), the Shareholder is obliged to either agree to the separate estate regime (Gütertrennung) or, in case he chooses the joint estate regime (Gütergemeinschaft), to declare his Shares as separate property (Vorbehaltsgut) and to register for the property registry (Güterrechtsregister).

b) In case a Shareholder is married under the community property regime, the Shareholder is obliged to agree not to be bound by the restrictions of sec. 1365 German Civil Code and that his Shares are not subject to the adjustment of matrimonial property (Zugewinnausgleich) if the matrimonial property regime ends otherwise than by death of a spouse [■or, alternatively, shall procure an irrevocable authorization by his spouse to dispose of his Shares].

2. Upon request in Text Form by the Company [■or any Investor], each Shareholder has to provide proof of the fulfillment of the obligations pursuant to Section 1 above without undue delay but no later than six months after receipt of the request.

3. The provisions set forth in Section 1 and Section 2 shall apply mutatis mutandis if a Shareholder is married under a different law than German law, which provides for similar provisions and institutions as said forth

above or is living in a registered partnership (eingetragene Lebenspartnerschaft) under German law or a similar institution under applicable foreign law.

4. In the event a Shareholder does not fulfill his obligation pursuant to Sections 1 to 3, upon request by [■ the Company/an Investor Majority], he shall be obliged to transfer all his Shares to the Company against payment of the total book value of such Shares (i.e., the respective percentage in the Company's equity determined according to sec. 266 para. (3) lit. A. HGB) based on the latest available audited (as the case may be) Financial Statements.

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.

Please note that the consequences above will apply regardless of whether or not the founder holds her shares directly or through a founder HoldCo. Although a transfer of shares in the company by the founder HoldCo would not be subject to the transfer restrictions set forth in sec. 1365 German Civil Code, the investment and shareholders' agreement will also often include transfer obligations regarding the founder's shares in the founder HoldCo (e.g., call-options if the founder leaves the company during the vesting period). For such transfers in the founder HoldCo, sec. 1365 German Civil Code will apply.

2. Employee Stock Option Plan

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.

Typical early-stage employee participation programs end up somewhere in the range between 10% and 20% of the company's nominal capital, with later-stage companies usually having smaller pools.

Equity-Based ESOPs and VSOPs

In the U.S., employee participation programs are often set up as "real", *i.e.*, equity-based, employee stock option programs (*ESOP*). A stock option gives a beneficiary the right to buy stock at a specified exercise price (or *strike price*). The beneficiary pays the exercise price and then receives the company stock. In Germany, similar equity-based ESOPs are rather unusual for a German technology company that has been set up as a GmbH. The main problems with an equity-based ESOP are:

- Having many beneficiaries in the company's cap table is problematic because in a GmbH, every shareholder has certain unalienable rights, including information rights or the right to challenge resolutions adopted by the shareholders' meeting.
- Shares and options in a GmbH are not freely transferable as such transfers require costly notarization in front of a notary in Germany and, in most cases, a consent by the shareholders' meeting.

Thus, virtual employee participation programs (*VSOP*) are much more frequent in Germany. VSOPs are designed to operate in a manner similar to an equity-based ESOP, but without delivery of actual shares or options. Rather, the beneficiaries obtain contractual claims (so-called *virtual shares* or *virtual options*) against the issuing company for a cash payment in case of a liquidity event if the liquidity event and other circumstances satisfy the terms of the plan. As with an actual stock option, the value of the cash-out for the virtual option would be based on the liquidity event value of the company's stock. VSOPs can potentially deliver similar value to beneficiaries as equity-based ESOPs without invoking the limitations associated with such ESOPs.



A CLOSER LOOK:

Key Questions and Terms for a Virtual Stock Option Plan

Virtual Shares and Beneficiary

- What is the size of the pool of virtual shares and what will be the nominal amount per virtual share?
- Who shall be an eligible beneficiary of the VSOP? Only employees of the company and its affiliates or also outside advisers and consultants?
- It should be clarified that a virtual share neither commercially nor legally corresponds to one (partial) share in the registered capital of the company. A virtual share solely represents the beneficiary's right to receive a payment (usually in cash) in case of an exit. The virtual share is used as an assessment basis (*Bemessungsgrundlage*) to calculate the gross amount of such a payment.
- Under which circumstances shall the company be entitled to amend or to substitute the VSOP by another participation program?

Allocation

- Who decides about the allocation of virtual shares to the beneficiaries and the terms of the allocation? While the shareholders' meeting and/or advisory board is usually permitted to approve the VSOP in its entirety, allocation decisions are usually made by the management board with the approval of the advisory board, and by the advisory board with regard to any allocation of virtual shares to members of the management board.
- The virtual shares are usually allocated to the respective beneficiary by executing an offer letter addressed to the beneficiary indicating the granting of a determined number of virtual shares. Other terms that can be set forth in an allocation letter include the applicable number of allocated virtual shares 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 virtual share to be taken into account when determining the payment amount to which the virtual shares shall be entitled in case of an exit.

Vesting and Forfeiture in Case of Leaver Events

- The virtual shares are usually subject to a vesting, often similar to the vesting provisions for the founders included in the investment and shareholders' agreement (see above under Chapter C.V).
- Will there be an accelerated vesting in case of an exit?
- The expiration of the vesting period is often suspended (*gehemmt*) for the duration of a beneficiary's (i) maternity or parental leave under applicable law, (ii) unpaid sabbatical, (iii) illness after the period of paid sick leave, or (iv) other suspensions of the employment or service agreement of the respective beneficiary.
- The virtual shares, including all rights for the beneficiary resulting from or in connection with the VSOP, are often made subject to certain conditions subsequent (*auflösende Bedingung*) and will be forfeited in the event of one of those conditions. It is not uncommon to provide that all unvested virtual shares will be forfeited in case of a good leaver event and all virtual shares (vested and unvested) in case of a bad leaver or if the beneficiary violates material obligations under the VSOP or his or her employment or service contract.

- Will there be a right of the company to compensate a good leaver beneficiary for the vested virtual shares, and if yes, how will the compensation payment be determined?

Exit Payments

- What constitutes a relevant “exit” (see also under Chapter C.IV.4)?
- How will the amount of an exit payment per virtual share be calculated? In a typical VSOP, the program will provide that the virtual shares 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 (or a fraction thereof if one virtual share does not correspond to a common share with a nominal value of EUR 1.00.) If there is a base or strike price per virtual share, the amount of the base or strike price would be deducted from the amount the beneficiary is entitled to.
- 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 his or her employment or advisory 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).

Further Limitations

- The virtual shares and the applicable pay-out amounts (if any) are usually not equitably adjusted in case of future capital increases (*i.e.*, no antidilution protection, with the exception of capital increases from the company’s own resources (*Kapitalerhöhung aus Gesellschaftsmitteln*)).
- No liability is assumed towards the beneficiary with regard to the outcome of the VSOP, the intrinsic value and the development of the virtual shares or to the development of the company and the occurrence of an exit. The company also makes no assurances regarding the tax treatment of any payments under the VSOP (wage taxes, etc., will apply).

Virtual Stock Option Plans and the Company’s Balance Sheet

As we have seen, virtual stock option plans usually give the beneficiaries a payment claim against the company. A start-up should keep in mind that even prior to the occurrence of an exit, it might have to accrue provisions for its (future) obligations under the plan. As the economic burden of the virtual stock option plan will fall on the shareholders — an acquirer would take the payment claims against the company into account when determining its offered purchase price — it may make sense for the shareholders to agree that they will

bear the costs of the virtual stock option plan and provide the company with sufficient means (according to the allocation rationale set forth in the liquidation preferences) in case an exit event triggers payment obligations under the plan. This way, accruing reserves for the obligations under the virtual stock option plan may be avoided. Details would need to be discussed with the company’s auditor.

T&C Control of Stock Option Plans

In Germany, both an equity-based ESOP and a VSOP and the individual agreements with employees will be subject to particular controls through courts under sects. 307 *et seq.* German Civil Code, as they are classified as standard business terms (*Allgemeine Geschäftsbedingungen*).

Thus, the provisions must be formulated clearly and may not unreasonably disadvantage employees. Eligible employees may not be chosen in a discriminatory manner or in breach of the German General Law on Equal Treatment. The latter is obvious, but even a general exclusion of part-time employees because of their reduced working hours would be unlawful. However, the consideration of only a particular hierarchical group may be justified.

Provisions on vesting and forfeiture are regularly the focus of interest. Such agreements are not generally unlawful, but legitimate individual interests of the employee have to be taken into account on a case-by-case basis. German employment law has set clear boundaries. A total loss of options vested over many years due to voluntary resignation of the employee has been determined on various occasions to be invalid, even when the contract includes a particularly broad and harsh bad leaver mechanism. This is because the employee would otherwise be unreasonably limited in her occupational freedom and would lose the compensation she already earned.

3. Noncompete and Nonsolicitation

Noncompete 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. Noncompete 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 noncompete, 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 noncompete 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. The noncompete 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 noncompete must be geographically limited to geography

in which the company has business dealings or concrete market-entry plans.

To give them teeth, breaches of a noncompete are often also sanctioned by a contractual penalty.

To address potential enforcement issues under German procedural law, it may make sense to include language such as the following in the noncompete (although there is currently no comprehensive body of case law confirming the validity of such an arrangement):

The Parties agree that in the case of a breach by a Founder or a Founder Holding Entity of the noncompete obligations set forth above, the remedies available to the Company under this Agreement are not sufficient to hold the Company fully harmless against the detriments suffered therefrom, and that, therefore, the Company shall be entitled to enforce any claims for specific performance by a Founder or a Founder Holding Entity of such noncompete obligations (Unterlassungs- und Beseitigungsansprüche) by injunctive relief (einstweiliger Rechtsschutz) without having to specifically establish irreparable harm or injury and without providing a bond or other collateral (Sicherheitenstellung).

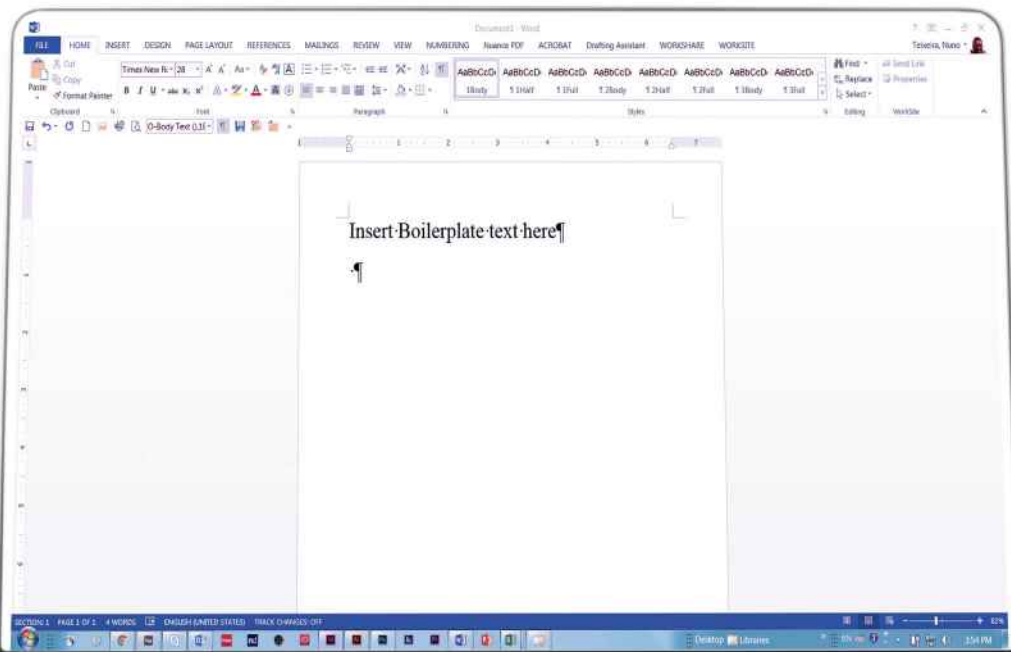
Nonsolicitation Undertakings

Nonsolicitation 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.

4. The “Boilerplate Clauses”

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
<p>Costs</p> <p>Unless the financing round is very small, it is standard that any notary fees and other public charges and costs in connection with the execution of the investment and shareholders' agreement and its implementation shall be borne by the company. Such other public charges and costs include the (usually rather small) fees for making filings with the commercial register and the (more substantial) fees for merger clearances in the rare cases where the closing of a financing round requires merger clearance (see above under Chapter B.II.2).</p> <p>While, as a principle, it's reasonable that each party shall bear its own charges, costs and fees and those of its advisers, investment and shareholders' agreements sometimes provide that reasonable expenses for 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.</p>	<p>Depending on the size of the financing and other provisions stipulated in the investment and shareholders' agreement, the notarization costs can be quite substantial.</p> <p>The German Act on Costs of Courts and Notaries (<i>GNotKG</i>) 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.</p> <p>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, he is allowed to charge a partial or even a full "drafting fee." It should therefore always be clarified that providing the documents beforehand is for information purposes only.</p> <p>Furthermore, the notarization of a non-German document is more expensive. The German Act on Costs of Courts and Notaries provides for an additional fee that is calculated on the basis of 30% of the value set for the investment and shareholders' agreement if such document is notarized in the English language. The same may apply for boilerplate clauses determining the governing law (please see below).</p> <p>If the company should reimburse the (lead) investor for the costs of outside counsel, that undertaking should be capped at a reasonable amount. To avoid iterative payments, it then makes sense to agree in the investment and shareholders' agreement that the respective investor shall be entitled to deduct such costs to be borne by the company from the amount the investor has to pay into the capital reserves of the company (for such payments, see above under Chapter B.II.1).</p>
<p>Confidentiality and Public Disclosures</p> <p>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 advisers 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.</p>	<p>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' agreement.</p> <p>As we have seen, the investment and shareholders' agreement 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 investment and 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.</p>

Boilerplate Clause	Comments
<p>Notices</p> <p>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' agreement, but allow more flexible means (including email, pdf and fax¹¹) for the day-to-day communication.</p>	<p>Given that in the day-to-day madness of start-up life, the parties will not consult the investment and shareholders' agreement but sooner or later resort to their default methods of communication (mostly emails), we suggest having clear rules when email communication is sufficient to make notices under the investment and shareholders' agreement. Here, it may make sense to refer to the "text form" as defined in sec. 126b German Civil Code, which comprises written communication, fax and emails.</p>
<p>Entire Agreement</p> <p>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 (<i>Rechtsgrund</i>) for any performances (<i>Leistungen</i>) rendered under such agreements and understanding during their term.</p>	<p>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.</p> <p>It can also be clarified that with the execution of the definitive investment and shareholders' agreement, the term sheet put forward by the investor during the negotiation that led up to the financing round shall be deemed terminated.</p>
<p>Amendments</p> <p>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.</p>	
<p>Successors and Assignments</p> <p>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.</p> <p>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.</p>	<p>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' agreement.</p>
<p>No Set-Off</p> <p>Usually, the parties will agree that except as provided otherwise in the investment and shareholders' agreement, no party shall be entitled to set off any rights and claims it may have under the agreement against any rights or claims any other party may have under the agreement, or to refuse to perform any obligation it may have under the agreement on the grounds that it has a right of retention. Exceptions to these general no-set-off and no-retention covenants include rights and claims of the relevant party claiming a right of set-off or retention that has been acknowledged in writing by the relevant other party/parties or has been confirmed by final decision of an arbitral tribunal or court.</p>	

¹¹ We can hear our U.S. colleagues laughing. Now it is out in the public, occasionally we still use faxes in Germany, and standard language in many agreements still makes reference to communication by fax. But given that in the U.S., cheques are more often than not still considered a normal payment method, we should be even. ☺

Boilerplate Clause	Comments
<p>Governing Law</p> <p>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.</p>	<p>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 (<i>nur klarstellender, nicht konstituierender Natur</i>).</p> <p>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.</p> <p>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.</p>
<p>Severability</p> <p>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' agreement should have unintended gaps (<i>unbeabsichtigte Regelungslücken</i>). Those shall be filled by provisions that come as close as what the parties would have agreed had they been aware of the gap.</p>	<p>This is another standard clause that should be included in any investment and shareholders' agreement.</p> <p>Please note that there are rulings by the German Federal Supreme Court (<i>Bundesgerichtshof</i>) 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.</p>

D ● **Appendix: Sample Term Sheet**

Term Sheet for a Series A Financing Round in

[Company Name]

This term sheet ("**Term Sheet**") summarizes the principal terms of the proposed financing ("**Financing Round**") of [■ Company Name], a German limited liability company, registered with the commercial register at the local court of [] under docket no. [] and having its registered offices at [] ("**Company**").

The transactions contemplated by this Term Sheet are subject to the satisfactory completion of due diligence.

The discussions have reached a state at which the parties wish to confirm their legally nonbinding preliminary agreement on certain aspects of the Financing Round and their rights and obligations as shareholders in the Company.

The Financing Round will be made pursuant to an investment and shareholders' agreement ("**ISHA**") drafted in English and governed by German law. [The Investors (as defined below), and respectively their counsel, shall prepare the draft ISHA and submit it to all parties for review no later than []. / The Company's counsel shall prepare the draft ISHA and submit it to all parties for review no later than [].]

Until the ISHA is signed by all relevant parties, there will not exist any binding obligation on the part of any party to consummate the Financing Round. This Term Sheet does not constitute a contractual commitment of any party, except for the paragraphs entitled "Confidentiality," "Expenses," "Exclusivity," "Governing Law and Jurisdiction" and "Binding Effect", which are intended to be binding on the parties.

Current Situation and Parties

Current Share Capital and Shareholdings

The Company's current fully paid-in share capital amounts to EUR [], divided into [] common shares with a nominal value of EUR 1.00 each. The shares in the company are currently held as follows:

Shareholder	Shareholding	Participation
[Founder 1]	EUR []	[]%
[Founder 2]	EUR []	[]%
[Angel 1]	EUR []	[]%

[Founder 1] and [Founder 2] are hereinafter referred to as the "**Founders.**" The Founders and [Angel 1] are hereinafter referred to as the "**Existing Shareholders.**"

Investors

- [Investor 1], [■ Details]; and
- [Investor 2], [■ Details]

[Investor 1] and [Investor 2] are hereinafter together also referred to as the "**Investors.**"

[■ As the case may be, provisions about a lead investor or option for additional investors to join within a certain period of time following Closing (so called Second Closing.)

Financing Round																				
Pre-Money Valuation	EUR [], on a fully diluted basis, where “fully diluted” includes outstanding options, warrants and convertible securities [▪, as well as (virtual) shares already allocated or available for future grants under the Company’s existing ESOP (as defined below)].																			
Investment	<p>The Investors will make an equity investment into the Company of a total amount of EUR [] as follows, reflecting a purchase price of EUR [] per each Series A Preferred Share (as defined below) (“Series A Preferred Share Price”):</p> <table border="1"> <thead> <tr> <th>Investor</th> <th>Nominal Capital</th> <th>Capital Reserve Payments</th> </tr> </thead> <tbody> <tr> <td>[Investor 1]</td> <td>EUR []</td> <td>EUR []</td> </tr> <tr> <td>[Investor 2]</td> <td>EUR []</td> <td>EUR []</td> </tr> </tbody> </table> <p>[▪ Alternatively or in addition: investment through convertible loans or contribution of existing convertible loan receivables or details of media for equity deal].</p> <p>[▪ As the case may be: staggered financing based on achievement of milestones].</p> <p>[▪ As the case may be: partial buy-out from Existing Shareholders].</p>		Investor	Nominal Capital	Capital Reserve Payments	[Investor 1]	EUR []	EUR []	[Investor 2]	EUR []	EUR []									
Investor	Nominal Capital	Capital Reserve Payments																		
[Investor 1]	EUR []	EUR []																		
[Investor 2]	EUR []	EUR []																		
Investor Majority	<p>“Investor Majority” means holding in aggregate []% or more of the Series A Preferred Shares (as defined below) [▪ and the existing Series Seed Preferred Shares].</p>																			
Type of Security and Number of Shares	<p>In the course of the Financing Round, the Company’s share capital shall be increased by a total amount of EUR [] against issuance of [] new shares with a nominal value of EUR 1.00 each (“Series A Preferred Shares”). To the exclusion of subscription rights of the Existing Shareholders, only the Investors shall be invited to subscribe for the Series A Preferred Shares as follows:</p> <ul style="list-style-type: none"> [Investor 1] shall subscribe for [] Series A Preferred Shares; and [Investor 2] shall subscribe for [] Series A Preferred Shares. <p>Following Closing (as defined below), the shareholder structure of the Company will look as follows:</p> <table border="1"> <thead> <tr> <th>Shareholder</th> <th>Shareholding</th> <th>Participation</th> </tr> </thead> <tbody> <tr> <td>[Founder 1]</td> <td>EUR []</td> <td>[]%</td> </tr> <tr> <td>[Founder 2]</td> <td>EUR []</td> <td>[]%</td> </tr> <tr> <td>[Angel 1]</td> <td>EUR []</td> <td>[]%</td> </tr> <tr> <td>[Investor 1]</td> <td>EUR []</td> <td>[]%</td> </tr> <tr> <td>[Investor 2]</td> <td>EUR []</td> <td>[]%</td> </tr> </tbody> </table>		Shareholder	Shareholding	Participation	[Founder 1]	EUR []	[]%	[Founder 2]	EUR []	[]%	[Angel 1]	EUR []	[]%	[Investor 1]	EUR []	[]%	[Investor 2]	EUR []	[]%
Shareholder	Shareholding	Participation																		
[Founder 1]	EUR []	[]%																		
[Founder 2]	EUR []	[]%																		
[Angel 1]	EUR []	[]%																		
[Investor 1]	EUR []	[]%																		
[Investor 2]	EUR []	[]%																		
Use of Proceeds	The Company will use the proceeds of the Financing Round exclusively for the development and the operation of the Company in accordance with a business plan and budget to be approved by the Investors prior to the Closing.																			
Representations and Warranties	<p>The Company and the Founders will give representations and warranties that are customary for a financing of this type.</p> <p>[▪ As the case may be: provisions regarding liability caps and remedies in case of a breach, e.g., definition of “Losses” and remedies by means of a compensatory share-capital increase or a compensatory exit-preference payment].</p>																			
Closing Conditions and Closing Date	<p>The consummation of the Financing Round (“Closing”) shall be subject to the following conditions precedent:</p> <ul style="list-style-type: none"> [▪ Merger clearance;] [▪ Completion of anti-money laundering checks by the Investors;] [▪ Transfer of certain assets, e.g., IP, from the Existing Shareholders to the Company;] [▪ Absence of any material adverse change in the business of the Company;] [▪ Completion of satisfactory due diligence review of the Company by the Investors, including technical, legal, IP due diligence;] [▪ Approval of the Investors’ respective investment committees; and] [▪ Other conditions resulting from the outcome of the due diligence exercise (if any).] 																			

Rights, Preferences and Restrictions of Series A Preferred Shares

Dividends

[■ As proposed by the Management Board (as defined below), except for the special dividend mentioned under Significant Transaction, and resolved by the shareholders' meeting of the Company, no dividend will be declared or paid on the common shares without a correspondent dividend on the Preferred Series A Shares.]

OR

[■ The holders of Series A Preferred Shares will be entitled to receive [■ non-]cumulative dividends in preference to the other shareholders at an annual rate of [■] % of the Series A Preferred Share Price from legally available funds and when, as and if resolved by the shareholders' meeting.]

Liquidation/ Exit Preference

In the event of any liquidation, dissolution or winding up of the Company (including any merger or consolidation) or the sale and/or out-licensing of more than 50% of the Company's assets (at fair market value) or the sale or contribution of more than 50% of all of the Company's shares in a single transaction or a series of related transactions (also in connection with the exercise of any rights of first refusal, drag-along and tag-along rights) [■ and an IPO] (each an "Exit Event"), the proceeds (after deduction of any transaction costs) shall be distributed as follows:

- The holders of Series A Preferred Shares that have participated in the Exit Event will be entitled to receive a one-time [■ participating/nonparticipating] preference in an amount per Series A Preferred Share equal to [1.00] times the Series A Preferred Share Price plus declared and unpaid dividends, if any; and
- All remaining proceeds shall be allocated between all shareholders *pro rata* to the nominal value of their divested shareholdings in the Company against the total nominal value of all divested shareholdings in the Company [■ provided that any amounts received by an Investor pursuant to the aforesaid paragraph shall be credited (*angerechnet*) against the amount to be paid to an Investor in accordance with this paragraph].

Conversion

Holders of Series A Preferred Shares will have the right to convert the Series A Preferred Shares at the option of the holder, at any time, into common shares at a ratio of 1:1.

Antidilution

In case of the issuance of shares in the Company for a total consideration per EUR 1.00 (*i.e.*, nominal capital plus any *agio* or contributions (in cash or in kind) to capital reserves) of the nominal capital of less than the Series A Preferred Share Price, the Investors shall be entitled to an antidilution protection based on a [■ broad-based weighted average/narrow-based weighted average/full ratchet], except for the following carve-outs:

- (i) Issuance of securities pursuant to currently outstanding warrants, notes or other rights to acquire securities of the Company;
- (ii) Issuance of shares to employees, consultants, officers or directors of the Company pursuant to an ESOP approved by the Investor Majority (including options granted prior to the Financing Round);
- (iii) [■ Issuance of ordinary stock in an IPO;]
- (iv) [■ Issuance of securities in connection with the acquisition by the Company of another company or business;]
- (v) [■ Issuance of securities in the course of a compensatory capital increase in case of a breach of any representation or warranty; and]
- (vi) Issuance of securities in any other transaction in which exemption from the antidilution provisions is approved by an Investor Majority.

[■ Pay-to-Play]

If any Investor fails to exercise in full their Right of First Offer described below with respect to an equity financing of the Company, [■ all / [■] % of such holder's Series A Preferred Shares shall automatically and without further action on the part of such holder be converted into an equivalent number of common shares; provided, however, that no such conversion shall occur in connection with a particular equity financing if, pursuant to the written request of the Company, the Right of First Offer with respect to such equity financing is waived.]

Protective Provisions	<p>Without the approval by an Investor Majority, the Company will not take any of the following actions and measures:</p> <ul style="list-style-type: none"> (i) Any action that liquidates, dissolves or winds up the business and affairs of the Company; (ii) Any sale or license of all or substantially all of its assets, including, but not limited to, any sale, license, lease or other disposition of any business, or division or other material rights, assets or intellectual property (in each case by asset or equity disposition, merger, business combination, license, partnership, joint venture, collaboration or otherwise); (iii) Any action that alters or changes the rights, preferences or privileges of the Series A Preferred Shares so as to adversely affect such shares; (iv) Amendment of the Company's articles in a manner that adversely affects the holders of the Series A Preferred Shares; (v) Payment of dividends or other distribution with respect to any shares in the Company; (vi) Establishment, termination or material changes to an equity-based or virtual stock option plan for directors, employees or consultants ("ESOP"); (vii) Purchasing or redemption of shares (excluding common shares repurchased/redeemed under an ESOP); (viii) Entering into, termination and material amendment of enterprise agreements within the meaning of sects. 291 et seq. of the German Stock Corporations Act (<i>Aktiengesetz</i>) or any measures under the German Transformation Act (<i>Umwandlungsgesetz</i>); (ix) Amendments of the rules of procedure for the Management Board and/or the Advisory Board; (x) <input type="checkbox"/> Increases or decreases in the share capital of the Company; (xi) <input type="checkbox"/> Creation or authorization of issuances of any debt security if the aggregate indebtedness of the Company and its subsidiaries for borrowed money following such action would exceed EUR [..]; (xii) <input type="checkbox"/> Establishment or acquisition or divestment of a participation in any subsidiary; (xiii) <input type="checkbox"/> Appointment or removal or prolongation of the term of any person as Management Board member and any decision concerning their remuneration; (xiv) <input type="checkbox"/> Approval of the financial results;] and (xv) <input type="checkbox"/> Any public listing of the shares in the Company.]
Information Rights	<p>The Company will deliver to the Investors:</p> <ul style="list-style-type: none"> • Audited annual and unaudited quarterly and monthly financial statements; • Annual budgets; and • Other information reasonably requested by the Investor. <p>In addition, the Company will permit the Investors or their authorized representatives to visit and inspect the properties of the Company, including its corporate and financial records, and to discuss its business and finances with officers of the Company during normal business hours following reasonable notice and as often as may be reasonably requested.</p>
Right of First Offer for New Securities	<p>In the event, other than the carve-outs described below, the Company proposes to offer equity securities to any person, each Investor will have the right to purchase that portion of such equity securities equal to the number of shares to maintain its ownership percentage in the Company. Such equity securities shall be purchased on the same terms as they are purchased by other third-party purchasers of the equity securities.</p> <p>The carve-outs to the Right of First Offer include:</p> <ul style="list-style-type: none"> (i) Issuance of securities pursuant to currently outstanding options, warrants, convertible notes or other rights to acquire securities of the Company; (ii) Issuance of common shares (or options therefore) under an ESOP (including options granted prior to the Financing Round); (iii) Issuance of ordinary stock in an IPO; (iv) Issuance of securities in connection with the acquisition by the Company of another company or business; and (v) Issuance of common shares in any other transaction in which exemption from the right of first offer provisions is approved by an Investor Majority.

Corporate Governance

Advisory Board

The Advisory Board will consist of up to [] voting board members who shall be appointed and revoked as follows: [].

[■ *As the case may be: provisions regarding observer members*].

The Advisory Board will decide with [■ simple majority/including the vote of at least one of the board members appointed by an Investor].

[■ *As the case may be: provisions regarding the format and frequency of board meetings and other procedural aspects*].

The Company will pay Advisory Board members' reasonable travel expenses. The Company will provide for appropriate D&O insurance for the Advisory Board members.

Consent Requirements

Certain matters having a material effect on the operation and/or management of the Company (or any of its current or future subsidiaries) will require the prior approval of the Advisory Board. [■ This approval shall include the affirmative vote of at least one Advisory Board member appointed by an Investor]. Such matters will include:

- (i) Initiation, conduct or settlement of material litigation;
- (ii) Determination of the annual business plan and any material deviation from the prevailing annual business plan;
- (iii) Any entering into, material amendment or termination of contracts or agreements with a value of, or resulting in expenditures of the Company of, more than EUR [];
- (iv) Any change to the auditors;
- (v) Any granting of a license not in the ordinary course of business;
- (vi) Any change to the principal business, or to enter new lines of business, or exit the current line of business;
- (vii) Any related party transaction;
- (viii) Any approving of a bonus scheme, employment incentive plan or identifying beneficiaries under a bonus scheme or employment incentive plan;
- (ix) Any change to the accounting policies;
- (x) The appointment or removal of any key employee with an annual gross salary exceeding EUR [] or any manager and any decision concerning their remuneration;

Unless any of the above matters (y) were already approved in the relevant annual business plan or (z) require a decision by the shareholders in accordance with the terms of this Term Sheet or under mandatory applicable law.

Share Transfers

General Rules	All Company's shares shall be registered shares. The transferability shall be restricted (<i>Vinkulierung</i>) [■ ; any transfer shall internally require the consent of the Advisory Board].
Founders' Lock-up	At no time prior to the [■ fourth] anniversary of the Closing will any Founder or other key board and management members, if any, (to be defined) dispose of any shares in the Company in any manner except with the prior approval of the Investor Majority. This lock-up will, in any case, lapse at the time when the Company is listed at a national or international stock exchange or an Exit Event occurs.
Right of First Refusal	If a shareholder proposes to transfer their shares, the Investors shall have the right of first refusal at the same price and conditions as the shares are offered. If not all of the other Investors intend to exercise their right of first refusal, the remaining Investors may acquire those shares, too. However, the right of first refusal must be exercised for all offered shares, otherwise the selling shareholder is entitled to sell all offered shares to the potential buyers.
Co-Sale Right	[■ Holders of Series A Preferred Shares shall have the right to participate on a <i>prorata</i> basis in transfers of shares by the Founders (with customary exceptions for transfers in connection with estate planning and similar matters). This right will terminate immediately prior to the IPO or an acquisition of the Company.] OR [■ Upon any transfer of shares to a third party by a Founder, the Investors will each have a <i>prorata</i> tag-along right, at their discretion. Upon any transfer of shares to a third party by an Investor, the other Investor will have a <i>prorata</i> tag-along right. Upon any transfer of shares to a third party, resulting in a change of control of the Company or an Exit Event, all shareholders will all have a <i>prorata</i> tag-along right.]
[■ Special Drag-Along Right for the Investors]	Upon request by an Investor Majority, the remaining shareholders shall sell their shares in the course of a transfer of shares at terms and conditions accepted by an Investor Majority at any time after the [■ fourth] anniversary of the Closing. The Investors with an Investor Majority may determine that a person be authorized to negotiate the terms and conditions of such a transaction. Such negotiator shall be given a mandate (<i>Beauftragung</i>) and shall be authorized (<i>Bevollmächtigung</i>) by all shareholders and the Company to negotiate all terms and conditions with the prospective acquirer(s) and to enter into the contract with the acquirer(s).

Vesting	
Vesting Shares and Vesting Period	<p>[_] % of the shares held by each Founder ("Vesting Shares") shall be subject to a vesting and a call-option in case of a Good Leaver or Bad Leaver (as each is defined below).</p> <p>Vesting period shall be four years following Closing ("Vesting Period"); 1/48 of the Vesting Shares shall vest each month subject to customary suspension rights. If a Leaver Event occurs within the first twelve months, no Vesting Shares shall be vested (<i>cliff</i>).</p> <p>[<input type="checkbox"/> If an Exit occurs during the Vesting Period, an additional [33] % of all unvested Vesting Shares shall vest immediately prior to the occurrence of the Exit (accelerated vesting).]</p>
Good Leaver	<p>"Good Leaver" means, with respect to any Founder, the occurrence of any of the following:</p> <ul style="list-style-type: none"> (i) Their employment or service contract with the Company ("Contract") or appointment as a member of the Management Board (as the case may be) is terminated/revoked other than for good cause (<i>wichtiger Grund</i>); (ii) The respective Founder terminates their Contract or resigns from their appointment as member of the Management Board (as the case may be), in each case for good cause; (iii) Their death; (iv) Their Contract being terminated by either party due to [<input type="checkbox"/> permanent disability (<i>dauerhafte Berufsunfähigkeit</i>)/disability; the parties clarify that "disability" means any physical or mental illness or injury, as a result of which such person fails to render the services required of them, for a period of two successive months, or an aggregate of three months in any twelve-month period and that disability shall be deemed to occur upon the end of such two-/three-month period; or (v) [<input type="checkbox"/> The Advisory Board having resolved to treat such person as a Good Leaver.]
Bad Leaver	<p>"Bad Leaver" means, with respect to any Founder, the occurrence of any of the following:</p> <ul style="list-style-type: none"> (i) Their Contract or appointment as a member of the Management Board (as the case may be) is terminated/revoked for good cause; the parties clarify that "good cause" shall include any reasons for which the Founder is responsible that allow the Company to extraordinarily terminate the Contract; (ii) The respective Founder terminates their Contract or resigns from their appointment as member of the Management Board (as the case may be), in each case without good cause; (iii) The respective Founder has become insolvent or unable to pay their debts as they fall due or has been adjudicated bankrupt or, whilst insolvent or bankrupt, has compounded or proposed or entered into any reorganization or other special arrangement with their creditors generally; or (iv) An encumbrancer has taken any step in relation to enforcing any security rights or claims into the shareholdings held by the Founder.
Call-Option	<ul style="list-style-type: none"> • [<input type="checkbox"/> Unvested Shares / Vesting Shares (but only in case of a Good Leaver Event that occurs within the first [_] years after Closing)] in case of a Good Leaver; and • [<input type="checkbox"/> Vesting Shares (but only in case of a Bad Leaver Event that occurs within the first [_] years after Closing)] in case of a Bad Leaver.
Purchase Price	<ul style="list-style-type: none"> • [<input type="checkbox"/> Fair market value] for the vested shares and [<input type="checkbox"/> book value/nominal value for the unvested shares] in case of a Good Leaver; and • [[_] % of the fair market value for the vested shares and nominal value for the unvested shares/[<input type="checkbox"/> book/nominal value] for all Vesting Shares] in case of a Bad Leaver.

Miscellaneous

Exclusivity	From the date of the last signature below and for the next [] days, the Company shall not, and the Company shall cause its officers, directors, employees, advisers, representatives and other agents not to, enter into or continue any discussions or negotiations or make any agreement with any third party concerning a possible equity investment or loan or other type of funding, directly or indirectly.
Confidentiality	The terms and conditions described in this Term Sheet, including its existence, shall be confidential information and shall not be disclosed by the undersigned parties to any third party. If an undersigned party determines that it is required by law to disclose information regarding this Term Sheet or to file this Term Sheet with any regulatory or governmental authority, it shall, a reasonable time before making any such disclosure or filing, consult with the other undersigned parties regarding such disclosure or filing and use its best efforts to obtain confidential treatment for such portions of the disclosure or filing as may be requested by any of the other undersigned parties.
Expenses	<p>[If the Financing Round is consummated, the Company will assume the costs and expenses of the Investors for outside counsel up to a total amount of EUR [].]</p> <p>OR</p> <p>The Company and the Investors will each bear their own expenses with respect to the transactions contemplated in this Term Sheet, except that:</p> <ul style="list-style-type: none">(i) If the Closing is completed;(ii) If the Closing Conditions are all fulfilled and the Company and/or the Existing Shareholders refuse to complete the Financing Round;(iii) If the Company or the Existing Shareholders violate any of the restrictions set forth in the section "Exclusivity" below; or(iv) In case the Company or the Existing Shareholders do not close the Financing Round but close an M&A deal or financing round with a third party within three months from the signing of this Term Sheet. <p>The Company will promptly, upon request thereof, reimburse the Investors any costs and expenses for outside counsel incurred with respect to the Financing Rounds subject to an aggregate cap of EUR [] plus VAT, if any.</p>
Binding Effect	<p>This Term Sheet is nonbinding. Only the following clauses of this Term Sheet shall legally bind the parties:</p> <ul style="list-style-type: none">• Exclusivity;• Confidentiality;• Expenses;• Binding Effect;• Governing Law and Jurisdiction;• Severability; and• Validity.
Governing Law and Jurisdiction	This Term Sheet and all acts and transactions pursuant hereto and the rights and obligations of the parties hereto shall be governed, construed and interpreted in accordance with the laws of Germany, without giving effect to principles of conflicts of law.
Severability	If individual binding sections of this Term Sheet are wholly or in part invalid, the other binding sections shall retain their validity. The ineffective sections shall be deemed replaced by the provision the parties would probably have agreed to had they been aware of the invalidity of the section concerned.
Validity	This Term Sheet is valid until [].

E ● **Our International Platform for Technology Companies**

Dedicated to the needs of technology companies and their investors

Orrick counsels more than 1,800 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, and M&A exits (*Pitchbook*).

Oracle Microsoft NVIDIA
Intel Cisco Pinterest Stripe
23andme eHarmony SoFi
Betterment Planet Labs



The leading German legal data base *Juve* nominated us for **Private Equity and Venture Capital Law Firm of the Year 2017** in Germany.



Tech Group of the Year

2X
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Legal 500



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PitchBook



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."



State of European Tech

The 2017 State of European Tech Report prepared by *Atomico* in collaboration with *Slush* and supported by Orrick and Silicon Valley Bank, is the latest evidence of Europe's growing influence in the global tech ecosystem.

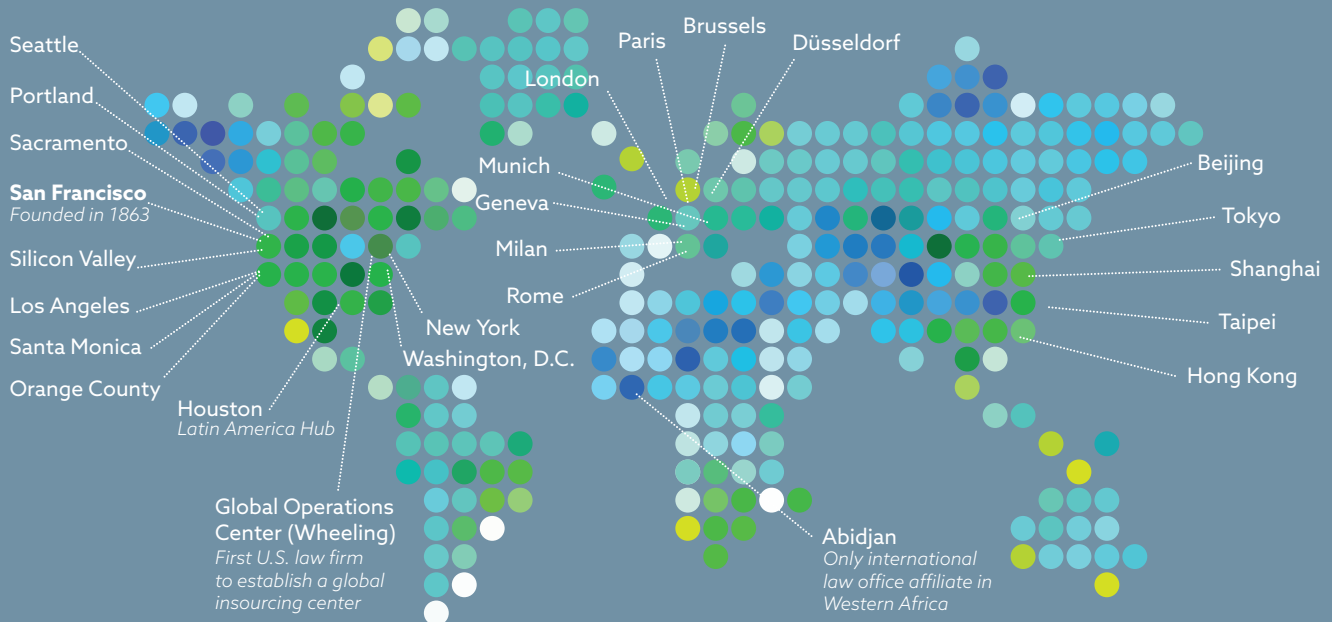
We advise tech companies at all stages:

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≈ 20% of all **US\$ 1 Billion+ Unicorns** in the U.S. Market (either company- or investor-side)

6 of the **Fortune 10** TMT Companies

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Nest

US\$3.2 billion acquisition by Google

Seller's Counsel

Yammer

US\$1.2 billion acquisition by Microsoft Corporation

Seller's Counsel

Instagram

US\$1 billion acquisition by Facebook (U.S.)

Seller's Counsel

Cruise

Over US\$1 billion acquisition by General Motors

Seller's Counsel

TOA Technologies

Acquisition by Oracle (terms not disclosed)

Seller's Counsel

AVG

US\$1.3 billion acquisition by Avast

Seller's Counsel

Apple

Acquisition of WiFiSlam and Siri (terms not disclosed)

Acquiror's Counsel

Pinterest

Acquisitions of Kosei (terms not disclosed)

Acquiror's Counsel

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A truly global platform.

F About ● the Authors

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Sven Greulich advises technology companies on complex cross-border mergers and acquisitions, as well as private equity and venture capital investments. Sven is passionate about building a bridge for his clients from Germany to Silicon Valley and other global technology hubs. With a dual background in business and law, an entrepreneurial spirit, and experience in over 100 M&A transactions and financing rounds, Sven has a unique perspective that inspires him to find the best strategic and commercially viable solution for his clients. In the 2017 edition of its Innovative Lawyers Report Europe, the *Financial Times* named Sven's work to connect start-ups with Germany's *Mittelstand* (mid-sized companies) a standout "for making bridges between Silicon Valley and Germany."



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Fabian von Samson-Himmelstjerna is a member of Orrick's M&A and Private Equity Group. He focuses his practice on private and public M&A, private equity and venture capital, with an emphasis on cross-border transactions. Fabian represents German and international financial institutions, corporate entities, financial investors, founders and members of management, in particular on acquisitions and divestitures, public takeovers, joint ventures, carve-outs and portfolio transactions. He has specific industry expertise in the technology, banking and financial services (including fintech), engineering and automotive business as well as in the smart/renewable energy sector.



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Shawn Atkinson is a member of the European Technology Companies Group who advises leading private equity, venture capital, growth funds and high-growth technology companies. He has a particular depth of experience in technology and IP-rich businesses and is a recognized leader in late-stage venture transactions and in early-stage private equity transactions in Europe and emerging markets. A cross-border transactional lawyer by trade, his experience includes U.K. multijurisdictional and complex corporate transactions for both public and private companies, including countless acquisitions and disposals, cross-border mergers, bankruptcy-infused asset sales, recapitalizations and reorganizations. Shawn has been a "recommended individual for Venture Capital and Mid Market M&A" by *Legal 500 U.K.* in each of the last four years.



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Christian Schröder is head of the German IP/IT & Data Privacy Group. Christian advises start-ups to large multinationals on IP, unfair and deceptive trade practices, e-commerce, IT and data privacy/data protection. Christian provides IP/IT advice in M&A transactions and advises on IP-focused joint ventures. As a core member of Orrick's global Cyber, Privacy and Data Technology practice group, Christian has also special focus on data privacy/data protection matters. In particular, Christian advises on a risk-based approach to privacy, on implementing databases and new software applications and, in particular, cloud-based solutions. Christian has commented, *inter alia*, on Chapter V of the new EU General Data Protection Regulation (International Data Transfers) in: Kühling/Buchner, DSGVO, 2017.

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André Zimmermann is head of the German Employment Group. He advises German and international companies in all areas of individual and collective employment law. The main focus of André's practice includes employment aspects of M&A transactions, restructuring, outsourcing and headcount reduction, multijurisdictional and cross-border employment issues, service agreements of managing directors and board members, codetermination of employees at operation and board level, collective bargaining and negotiations with works councils, trade unions and litigation.

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Karsten Faulhaber brings more than a decade of experience as counsel and arbitrator. However, his proficiency goes beyond just arbitration, as he has deep knowledge in dispute resolution in many forms, and his background in transactional law allows him to provide solutions to clients' problems — often before they even reach a courtroom. He has been praised in *Chambers Global* for his "proactive and skillful" approach to arbitration. Karsten represents clients in arbitrations under various German and international rules but also regularly acts as arbitrator. In addition, he frequently represents global enterprises in international disputes before the national courts. When he originally started practicing law, Karsten was an M&A lawyer, and as a result, he has extensive transaction experience. But the opportunity to work in dispute resolution and especially arbitration appealed to him as it reminded him of his passion for the game of chess. Much in the same way he calculates strategy when playing the game, he sees in complex disputes the importance of thinking ahead, anticipating the moves of the other parties, the temperament of the opponents and, ultimately, the fight to win.



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Nicholas Kessler is a member of the International Arbitration Group. He focuses on national and international arbitration and complex litigation, predominantly with regard to post-M&A, restructuring and corporate law, antitrust damages, and particularly construction disputes. Nicholas has extensive experience with arbitral proceedings under the auspices of all of the major arbitral institutions and rules (e.g., ICC, DIS, SCC, LCIA, UNCITRAL, ICSID, *ad hoc*). He also regularly advises on general commercial law matters such as product liability and distribution law. Nicholas is a visiting lecturer at the Universities of Münster, where he teaches international arbitration and mediation in the university's post-graduate program. He is also a visiting lecturer at the University of Düsseldorf for European and International Civil Procedure.

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Till Steinvorth is head of the German Antitrust and Competition Group. Till focuses on German and European antitrust law. He has extensive experience in merger control matters and in cartel investigations; he regularly represents clients before the German competition authority and the European Commission. An additional highlight of Till's practice includes antitrust damages claims and his pursuit of international trade and compliance matters, including matters involving foreign investment filings in Germany.

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Stefan Schultes-Schnitzlein is head of the German Tax Group. Stefan is both qualified as a German lawyer and as a German tax adviser. He advises industry clients, private equity funds and financial institutions on all sorts of German tax and accounting issues, usually with a transactional background. Stefan's focus is on corporate and real estate transactions, financings, refinancings and restructurings as well as on tax field audits and tax litigation in connection with any of the former. Stefan has advised several German start-ups on their flip to a U.S. holding company as part of larger venture capital financings.

Helpful Sources

Other Orrick Guides

Go West: Venture Financings and Expansion Projects in the United States - Practical Guidelines for German Technology Companies
Orrick, Herrington & Sutcliffe, July 2017.

available at: <https://www.orrick.com/Insights/2017/07/Go-West-Venture-Financings-and-Expansion-Projects-in-the-United-States>

Corporate Venture Capital 2017 - Structures, Challenges & Success Factors
Orrick, Herrington & Sutcliffe, July 2017.

available in German and English at: <https://www.orrick.com/Insights/2017/06/Corporate-Venture-Capital-2017>

Books

Daniel Kahneman
Thinking, Fast and Slow
Penguin, 2012.

In this international bestseller, Nobel Prize winner Daniel Kahneman distills 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.

Brad Feld & Jason Mendelson
Venture Deals
3rd edition, John Wiley and Sons, 2016.

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

Mahendra Ramsinghani
The Business of Venture Capital
2nd edition, John Wiley and Sons, 2014.

Focused on the U.S. venture capital market but also valuable for German market players, it is a pretty comprehensive insight into venture capital investments seen from the investor's perspective with data, industry trends and insights from leading U.S. investors and their financial sponsors.

Noam Waterman
The Founder's Dilemmas - Anticipating and Avoiding the Pitfalls That Can Sink a Startup
Princeton University Press, 2013.

Though less comprehensive than the seminal book by Kahneman mentioned above, this book is a good read for entrepreneurs and very early-stage investors alike as it draws on the insights from behavioral economics when examining the most important decisions entrepreneurs will face: should they go it alone, or bring in cofounders, hires, and investors to help build the start-up?

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