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Country Q&A

Venture capital investment in Germany: market and regulatory overview

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MARKET OVERVIEW

1. What are the main characteristics of the venture capital market in your jurisdiction?

Venture capital and private equity

Venture capital (VC) and private equity are ways for unlisted companies to raise capital. Generally, private equity involves equity investment in unlisted companies such as VC, buyouts and mezzanine investments. In contrast with VC, it is considered to consist of the equity financing of experienced, already established companies, such as in management buyout (MBO) situations.

VC involves temporarily allocating equity capital to young, innovative, non-stock market listed companies at an early stage (seed or start-up), when the company offers above-average potential for growth, despite generally insufficient earning power. Investment also takes place at the expansion stage.

Sources of funding

In 2013, the investors in German VC and private equity funds were divided as follows (*German Private Equity and Venture Capitalist Association (Bundesverband Deutscher Kapitalbeteiligungsgesellschaften) (BVK) Statistics for 2013*):

- Private investors 29.8%.
- Funds of funds: 15.1%.
- Insurance companies: 13%.
- Pension funds: 11.4%.
- Family offices: 10.8%.
- Foundations: 6.3%
- Banks: 1.2%

A corresponding overview for 2014 has not yet been published by the BVK.

Types of company

VC investors prefer to invest in young, innovative, unlisted companies. Most targets have a low sales volume and few employees. General requirements for targets include:

- A convincing and sound business concept.
- Distinct intellectual property (IP) and patents.
- Sufficient basis for economies of scale.
- Market potential.
- Authentic, committed and qualified founders and key personnel.
- Sufficient exit opportunities.

VC investment targets in the first half of the year 2014 were similar to in 2013, mainly in the corporate and industrial services, computer and consumer electronics and corporate and industrial products sectors, including:

- Corporate and industrial services: 21.1% (18.2%).
- Life sciences: 16.5% (13.9%).
- Computer and consumer electronics: 15.6% (15.1%).
- Communication technologies and contents: 11.8% (10.1%).
- Corporate and industrial products: 10.9% (14.1%).
- Consumer goods and trade: 9.6% (10.4%).
- Consumer services: 4.9% (6.4%).
- Energy and environment: 4.7% (4.1%).

Market trends

The investment volume during the first half of 2014 amounted to EUR2.792 billion, which was only a slight decrease from the second half of 2013's EUR2.895 billion. However, it was significantly higher compared to the investment volume of EUR2.032 billion in the first half of 2013 (*BVK Statistics for the first half of the year 2014*).

Regarding the number of funded companies the regional focus of VC investment in 2013 was as follows:

- 23.1% (13%) in Baden-Wuerttemberg.
- 18.5% (17.5%) in Bavaria.
- 13.2% (12.7%) in Berlin.
- 8.5% (9%) in North Rhine Westphalia.
- 6.7% (9%) in Schleswig-Holstein.

Bavaria had 41% (33.9%) of the total investment amount in VC in the first half of 2014. Baden-Wuerttemberg had 13.4% (14.7 %), Berlin had 12% (16.7 %) and North Rhine Westphalia had 10.8%. Therefore, four of 16 federal states had more than three-quarters of the total VC-investment volume in the first half of 2014.

2. Are there any recent or proposed regulatory changes affecting the venture capital industry?

Repeal of Act for the Promotion of Venture Capital Participations

Due to the decision by the European Commission (Commission) in September 2009 (*Decision 2010/13/EC on aid scheme No C2/09 Germany intends to grant to modernise the general conditions for capital investments (Decision 2010/13/EC)*) the Act for the Promotion of Venture Capital Participations was repealed with effect from 24 December 2013.

The Commission declared that the scheme introduced by the Act on the Modernisation of Framework Conditions for Venture Capital and Equity Investments (*Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungsgesellschaften*) (MoRaKG), especially the Act for the Promotion of Venture Capital Participations (*Wagniskapitalbeteiligungsgesetz*) (WKBG), contravenes the regulations of the European single market. They interfered with the freedom of establishment and the risk capital guidelines of the EU.

Intended Venture Capital Act

The grand coalition intends to establish a new specific Venture Capital Act as one measure to improve the conditions for equity investments in young, innovative and fast growing companies, through creating a better legal framework. The German Private Equity and Venture Capitalist Association (BVK) has issued its own draft Venture Capital Act to illustrate the industry's ideas to improve the conditions for VC investments.

Act on the Protection of Retail Investors (*Kleinanlegerschutzgesetz*)

The government has proposed new legislation that will become effective in mid-2015, aiming to improve the legal protection of retail investors. This initiative is a reaction to the insolvency of PROKON Regenerative Energien GmbH (a renewable energy project developer who raised about EUR1.4 billion through profit-sharing rights which were sold predominantly to retail investors). However, the planned act may have an adverse impact on the further development of crowdfunding as a new source of financing for young, innovative and fast growing companies. This is because the planned act stipulates a prospectus requirement for, among others, subordinated loans and other types of investment contracts widely used for crowdfunding. While the proposed act does include certain clauses and exemptions intended to protect the crowdfunding industry, the crowdfunding-specific rules will only apply under the condition that restrictive maximum caps for investment amounts are met (EUR1,000 to EUR10,000 per individual investor; EUR1 million per funding). Further, the planned act prohibits advertising for investment opportunities in social media.

AIFM Directive

Directive 2011/61/EU on alternative investment fund managers (AIFM Directive) was implemented into German law by the Capital Investment Act (*Kapitalanlagegesetzbuch*) (KAGB) which came into effect on 22 July 2013. The KAGB provides a regulatory framework regarding the management of alternative investment funds (AIF) (that is, the AIF Manager (AIFM) needs a licence for the provision of portfolio and or risk management of an AIF). Whether a VC fund qualifies as AIF (and therefore the management of a VC fund is regulated by the KAGB) depends on the service scope and specific structure of the managed VC funds (*see Question 9*). The regulatory framework of the KAGB has already been adjusted partly through the *Finanzmarktanpassungsgesetz* (also known as *KAGB-Reparaturgesetz*) with effect from 15 July 2014. The main modification affects the definition of closed-ended and open-ended funds (*geschlossene und offene Fonds*). The need for this modification was a consequence of the inconsistency of its previous regulations with those of the new (directly applicable) Regulation (EU) 694/2014 supplementing Directive 2011/61/EU with regard to regulatory technical standards determining types of alternative investment fund managers. In relation to open-ended funds, the KAGB now cross-references to the definition in Regulation (EU) 694/2014, with the effect that closed-ended funds require the shares to be re-bought or taken back after the beginning of the liquidation period or phasing-out period at the earliest. However, specified grandfathering regulations for funds that were regarded as closed-ended funds have been introduced. Closed-ended funds are the predominant VC fund type (*see Question 7*).

European Venture Capital Funds Regulation

In addition, Regulation (EU) 345/2013 on European venture capital funds (EuVECA) (European Venture Capital Funds Regulation) applies since 22 July 2013. This was adopted to encourage and support the important character of VC companies, that is, stimulating growth in small, innovative businesses but also providing valuable expertise, business contacts and strategic advice. The European Venture Capital Funds Regulation is directly applicable in Germany and does not require implementation into German law (*see Question 9*).

INVEST - Grant for Venture Capital (*Wagniskapital*)

The Federal Ministry of Economy and Energy has renamed its funding action for investments in venture capital to "INVEST – Grant for Venture Capital" and adjusted its regulations to the characteristics of the German venture capital market with effect from 22 April 2014. The aim is to improve the funding conditions for new and innovative companies through venture capital by business angels. To be eligible for the INVEST grant, a company must either:

- Be active in an innovative sector (which are listed).
- Be the owner of a patent that is no older than 15 years and is related to its field of action.
- Have been granted public funding during the last two years before the application.

Further, the requirements to obtain the INVEST grant where the business angel investment is provided through a limited liability company have been relieved.

TAX INCENTIVE SCHEMES

3. What tax incentive or other schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

As the repealed Act for the Promotion of Venture Capital Participations infringed EU law (*see Question 2*), most VC funds are not subject to a specific VC tax regime, but fall under the general tax rules or the new AIFM tax rules.

However, under the INVEST - Grant for Venture Capital scheme (*see Question 2*), a new tax exemption (*section 3(71), Income Tax Act*) was established. Under this tax exemption, a public grant for the purchase of shares may be tax exempt up to 20% of the purchase price of the respective shares, but is limited to EUR50,000.

General tax rules

The tax treatment depends on whether the VC fund is a partnership or a corporation.

Partnership. If the VC fund is a partnership, German trade tax (*Gewerbesteuer*) is payable at a general rate of about 15% if the partnership qualifies as a commercial partnership.

An administrative decree dated 16 December 2003 (*Federal Tax Gazette I 2004, p.40*) provides guidelines for when a VC (or private equity) fund qualifies as non-commercial (that is, non-trading, *vermögensverwaltend*) and therefore can avoid trade tax at fund level. The criteria for non-commercial activities are roughly as follows:

- No bank facilities/no assumption of security. As a rule the VC fund should be financed by equity capital only. It is also detrimental if the fund takes over the risk of liabilities of the portfolio companies.

- No major organisation of its own. The fund should not have a large organisation to administer its assets. If the fund maintains its own office and personnel, it is not detrimental if this does not exceed the appropriate size.

- No market activity. The fund should not take part in the general market and distribute its special knowledge to other participants.

- No offer to the wider public. The fund should not offer the portfolio companies to the public. The fund should act on its own account.

- No short-term participations. Participations of the fund must be held for at least three to five years, and not on a short-term basis.

- No reinvestments of sales proceeds. The fund proceeds should be distributed to the investors and not reinvested.

- No management activity in the portfolio companies. The fund should not take over active management functions of the portfolio companies, as an entrepreneur would do. It is only allowed that the fund's staff become members of the supervisory board, or take over a similar function in the portfolio company.

- No commercial infection. The fund must avoid itself receiving any commercial income as defined in the Income Tax Act (*section 15*), as well as a participation in another commercial partnership.

- No deemed commercial activity due to legal form. If the fund is organised in the legal form of a GmbH & Co. KG, the fund qualifies as a commercial partnership because of its legal nature (*section 15(3)(2), Income Tax Act*). This general rule also applies to VC funds. However, this can be avoided if there is another managing shareholder besides the corporate general partner.

Corporation. If the VC fund is a corporation, the fund is subject to the ordinary rules of taxation of corporations. The corporate income tax rate of 15% (plus solidarity surcharge of 5.5%) applies.

In general, a corporate VC fund's income is also subject to trade tax. There is only one exemption: *Unternehmensbeteiligungsgesellschaften (UBB)* are trade tax–exempt (*section 3(23), Trade Tax Act*).

New AIFM tax rules

The general tax rules (*see above, General tax rules*) do not apply if the VC fund is covered by the special rules for open-ended funds in the Investment Tax Act (*Investmentsteuergesetz*). Since the implementation of the AIFM Directive, the Investment Tax Act now applies to:

- Undertakings for collective investment in transferable securities (UCITS).

- Alternative investment funds (AIF), such as private equity or VC funds.

The Investment Tax Act provides for a special tax transparent regime for open-ended investment funds. The income of an open-ended investment fund is exempt from corporate income and trade tax. Taxation only takes place at shareholder level.

To qualify as a tax-transparent investment fund, the fund must, among other things, meet the following criteria (*section 1(1b), Investment Tax Act*):

- The UCITS or AIF is subject to supervision at its registered office.

- The shareholders have a right to return their shares at least once a year.

- The business purpose of the fund is restricted to investment on behalf of the shareholders. There is no entrepreneurial management of the assets.

- The asset management must be based on the principles of risk diversification. There are limits for certain categories of assets.

Therefore, the AIF tax rules provide a definition of open-ended funds which is not congruent with the regulatory definition (*see Question 2*).

If these conditions are not met, a fund is an investment company (*Investitionsgesellschaft*). In this case, the general tax rules apply (*see above, General tax rules*). Some special rules can apply which possibly lead to disadvantages for investors. However, this relates more to participations of German investors in foreign investment companies which are subject to a low tax regime. Most VC funds are covered by the new AIFM tax rules. However, for VC funds in the legal form of a new partnership the new tax act simply refers to the general tax rules so that no special provisions apply.

Tax free carried interest

If a VC fund qualifies as a non-commercial fund (*see above, General tax rules*), there is a tax benefit for carried interest payments for income tax purposes. Only 60% of carried interest payments generated by a VC manager (*section 3(40a), Income Tax Act*) are taxable. 40% of the carried interest payments are tax-exempt.

Loss deductibility

With respect to tax losses carried forward of a VC fund the general tax loss carry forward rules apply. In general, tax losses can be carried forward for an indefinite period of time. However:

- They can only be set off without limitation up to EUR1 million per business year.

- For tax loss carry forwards exceeding EUR1 million, the set-off against taxable income is only possible up to 60% of the taxable income. The remaining tax losses carried forward are deferred.

The transfer of shares in corporations with losses can trigger forfeiture of tax loss carry forwards:

- If more than 25% of the shares are transferred to one buyer, the tax loss carry forwards are forfeited on a pro rata basis, in proportion to the percentage of shares transferred.

- If more than 50% of the shares are transferred to one buyer, all of the tax loss carry forwards are forfeited.

Exemptions from this rule apply if either:

- 100% of the shares in the corporation with losses and the acquiring corporation are held (directly or indirectly) by the same shareholder.

- The tax loss carry forwards do not exceed the amount of the hidden reserves of the corporation with losses.

FUNDING SOURCES

4. From what sources do venture capital funds typically receive funding?

There are three major groups of VC investors (*BVK Statistics 2013*), listed in size order:

- Private investors/family offices (together, 41%).

- Independent funds and managing funds of institutional and private investors (funds of funds) (15%).

- Insurance companies (13%).

Private individuals, particularly high net-worth individuals and family offices, play a significant role in the VC market.

Institutional investors generally regarded venture capital investments as supplementary investments. Only 0.26% of institutional investment capital is invested in VC, and 1.3% into private equity investments generally (*study by Fleischhauer, Hoyer & Partner Private Equity Consultants, on behalf of the Federal Ministry of Economy, January 2008 (BMWi Study)*).

75% of VC fund managers prefer private individual investors, as they are more flexible concerning the portfolio strategy of the fund. However, an increase of corporate VC is to be expected as several major corporations such as Deutsche Telekom AG, Lufthansa AG and Commerzbank increased their investments in new funds or VC activities.

FUND STRUCTURING

5. Can the structure of the venture capital fund affect how investments are made?

The structure of a VC fund affects how investments are made because it dictates the restrictions imposed by corporate requirements or agreements, as well as tax issues.

For example, a VC fund structured as a non-commercial limited partnership will only invest in target companies that are corporations, to prevent commercial tax at fund level (*see Question 3, General tax rules*).

In a limited partnership (*Kommanditgesellschaft,* KG), investments can only be made in accordance with the limited partnership agreement. This agreement can limit, for example, the geographic or economic area of possible targets, or the maximum investment amount in one company.

A decision of a fund to be treated as one of the two categories that are specifically regulated (*see Question 7*) will influence the way investments are made, as specific provisions apply to these types of funds' activities.

6. Do venture capital funds typically invest with other funds?

VC funds generally co-invest with other funds (both German and foreign) to diversify investments and minimise risk. The number of targets a fund invests in is about 20 to 30 (*Investor Relations Committee of the European Private Equity & Venture Capital Association (EVCA), November 2009*).

The average volume of a VC fund ranges from less than EUR100 million to EUR200 million. Targets have an average total capital demand of EUR14 million. However, capital demand can be as high as EUR30 million. As a result of this high capital demand and the relatively high default number of investments in targets, if the fund does not co-invest a VC fund can only invest in five to ten targets, with a limited possibility to diversify and minimise risk.

7. What legal structure(s) are most commonly used as vehicles for venture capital funds?

In 2013, there were 178 fund management companies organised in the Federal Association of German Investment Companies (BVK), plus probably about 60 more relevant fund management companies which are not associated with the BVK (*BVK Statistics for 2013*).

Limited partnership

The most common legal structure for VC funds is the KG, with at least one general partner whose liability is unlimited. Usually, the general partner is a private limited company (*Gesellschaft mit beschränkter Haftung*) (GmbH) and the investors are the limited partners. For tax reasons, a second GmbH normally acts as a managing limited partner. This practice fulfils the requirement of the KAGB, as closed-ended funds must either be limited partnerships (KG) or stock corporations (AG).

Equity investment company

Before implementation of the KAGB (*see Question 2*), only two categories of VC/private equity funds were specifically regulated:

- Equity investment companies (*Unternehmensbeteiligungsgesellschaften, UBGn*) licensed under the Equity Investment Companies Act (*Unternehmensbeteiligungsgesetz*) (UBGG).
- VC investment companies licensed under the WKBG. The WKBG has been repealed with effect as of 24 December 2013.

The UBGG regulates funds' organisation and capital structure rather than legal form. The aim of the UBGG is to provide certain tax reliefs for VC funds only. It contains provisions that aim to prevent misuse of these tax reliefs.

An equity investment company must be approved by and registered with the Ministry of Economics of the federal state where it is domiciled.

To be recognised as an equity investment company, a company must do all of the following:

- Pursue the object of buying, holding and selling company shares (*Unternehmensbeteiligungen*) in terms of equity capital under section 1(1a) of the UBGG.
- Be located in Germany.
- Have a minimum share capital of EUR1 million.
- Avoid a holding structure, that is, a UBG that is a subsidiary of another company is generally not allowed to hold a majority interest (more than 49% of the voting rights) in any target company.

Foreign structures

Foreign legal structures, mostly limited partnerships from Guernsey and Jersey (using the European passport (*see Question 9*)) and Delaware, as well as the Luxembourg SICAR (*Société d' Investissement à Capital Risque*), are also commonly used for German VC funds.

INVESTMENT OBJECTIVES

8. What are the most common investment objectives of venture capital funds?

Closed-ended VC funds generally have a maximum holding period of ten years. However, some funds are evergreen (that is, with an unlimited holding period). Due to the current market conditions and negative climate for initial public offerings (IPOs), evergreen funds are considered more flexible.

VC investors expect an average annual rate of return of 15% to 20% and an average market potential of EUR300 million for their investee companies. Only 3% of targets applying for financing actually receive funding.

The average performance rate of return of VC funds is 3.3% (*EVCA Investor Relations Committee 2009*). The average performance rate of return of the top quarter of European VC funds is 13.4%. German VC funds have an average rate of return of 5%, with the top German VC funds' rate of return averaging 23%. These figures show that only the top German VC funds are able to achieve the expected rate of return and manage a return of two and half times the initial investment (after an average of four years' investment).

German VC funds generally seek to exit their investments within four to six years from the initial investment.

FUND REGULATION AND LICENSING

9. Do a venture capital fund's promoter, manager and principals require licences?

Depending on the service scope and the structure of a VC fund, its manager may require:

- A licence or simple registration under the KAGB, which implements the AIFM Directive (*see Question 2*).
- Registration under the European Venture Capital Funds Regulation (*see Question 2*).

KAGB

The KAGB has applied in Germany since 22 July 2013, to implement the AIFM Directive. The KAGB applies to the fund's manager, not to the fund itself. The KAGB does not apply to managers of VC funds if they only manage VC funds fully invested before 22 July 2013.

According to the KAGB, an investment fund is any undertaking for collective investment, which collects capital from a number of investors to invest it according to a predefined investment strategy for the benefit of its investors, and is not an operative active company outside the financial sector (*section 1(1), KAGB*). Therefore, almost every VC fund is subject to the KAGB.

KAGB licence. Since the KAGB provides several exemptions and transitional provisions, whether a VC fund management requires a licence under the KAGB has to be decided on a case by case basis. Not only portfolio-management but also risk-management may require a licence.

If the fund management does require a licence, the manager must apply for the licence at the German Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht,* BaFin) and comply with the strict provisions of the KAGB which affect, for example:

- The legal structure of the fund.
- The selection and management of the assets.
- Admitted investors.
- Remuneration of the management.
- Appointment of a depositary.
- Marketing and valuation requirements.

KAGB registration. The KAGB only requires registration (and not a licence) if a manager of a VC fund fulfils one or more of the following provisions:

- The manager only manages special funds with a total fund volume of no more than EUR100 million (including leverage) or EUR500 million (if no leverage and compliance with further requirements is ensured). Special funds are funds whose shares can only be purchased under a written agreement or the constitutional documents by professional investors according to Annex II of Directive 2004/39/EC on markets in financial instruments (MiFID) or semi-professional investors. Semi-professional investors are investors who either commit themselves to invest at least EUR10 million in an investment fund or at least EUR200,000. In the latter case, the following criteria must be met:
  - the investor has to declare that he is aware of the increased investment risk; and
  - the AIFM or its marketing company must have checked the experience and knowledge of the investor and be convinced that the investor is aware of the risks involved and that the financial commitment is still appropriate for the investor.
- The manager of the fund manages domestic retail funds (and special funds) with a total funds volume of no more than EUR100 million (including leverage). In this case, the VC fund manager has to fulfil, apart from registration, further requirements of the KAGB (for example, valuation, appointment of a depositary, marketing, product and transparency rules).
- The management is not an external fund manager, who manages a domestic retail fund whose assets do not exceed EUR5 million, and does not have more than five individual persons as investors.

Private equity funds are privileged in relation to the inclusion of leverage existing at the level of the investment structure (Regulation (EU) 231/2013 with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision). This means that, for AIF whose core investment policy is to acquire control of non-listed companies or issuers, the AIFM does not include in the calculation of leverage any exposure existing at the level of those non-listed companies or issuers. This is provided that the AIF or the AIFM (acting on behalf of the AIF) does not have to bear the potential losses beyond its investment in these companies or issuers. It is recommended to also consider further regulatory requirements that may apply with regard to the management or the distribution of funds (for example, under the German Banking Act (*Kreditwesengesetz*) (KWG)).

European Venture Capital Funds Regulation

In contrast, the fund management may qualify for simple registration under the European Venture Capital Funds Regulation if the VC fund is not regulated as AIF under the KAGB. This sets out regulatory provisions similar to the KAGB, but they are not as far-reaching and can be seen as light-touch regulation (*see Question 2*). The European Venture Capital Funds Regulation stipulates provisions for the management of European Venture Capital Funds, for example:

- Selection and management of assets.
- Regular valuation.
- Management liability.
- Handling conflicts of interest.
- Investor protection.

If German managers of VC funds are registered according to the European Venture Capital Funds Regulation, they only have to comply with a manageable number of provisions under the KAGB.

The European Venture Capital Funds Regulation applies to managers of VC funds if all of the following apply:

- The assets under management in total do not exceed EUR500 million (if no leverage is applied).
- They are established in the EU.
- They manage portfolios of qualifying venture capital funds (European Venture Capital Funds).

In addition, the management of European Venture Capital Funds must register in its home member state.

To qualify as a European Venture Capital Fund, the VC fund must intend to invest at least 70% of its capital in qualifying investments. Qualifying investments are equity or quasi-equity instruments issued by qualifying portfolio undertakings. A qualifying portfolio undertaking:

- Is a company which, at the time an investment is made by the VC fund, is not admitted to trading on a regulated market.
- Is not allowed to employ more than 250 persons and its annual turnover does not exceed EUR50 million or the annual balance sheet does not exceed EUR43 million.
- Is not allowed to be a collective investment undertaking. If it is, the KAGB will apply. In addition, some companies cannot be a qualifying portfolio undertaking, for example credit institutions, investment firms, and insurance undertakings.

Further, a European Venture Capital Fund can only be marketed to:

- Professional investors according to Annex II section 1 of MiFID.
- Investors who have applied to be treated as professional investors according to Annex II section 2 of MiFID.
- Investors who invest at least EUR100,000, and declare in a separate document that they are aware of the risks associated with the envisaged commitment or investment.

Managers of VC funds who would like to certify their managed funds as a European Venture Capital Fund and be registered as European Venture Capital Fund managers must inform the competent authority in their home EU member state and provide the required information. Registration when granted will be accepted by every EU member state (European passport).

10. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

VC funds are either regulated as AIFs under the KAGB or as European Venture Capital Funds according to the European Venture Capital Fund Regulation (*see Question 9*). Only in rare cases are VC funds not regulated at all.

If shares in a VC fund are publicly offered in Germany, the offering will generally require a prospectus which must be approved by BaFin:

- If the VC fund qualifies as an investment fund under the KAGB, the VC fund prospectus is governed solely by the KAGB.
- If participations in the VC fund qualify as securities under the Securities Prospectus Act (*Wertpapierprospektgesetz*) (WpPG) and are distributed in a public offering, the prospectus must comply with the WpPG.

If the VC fund does not qualify as an investment fund according to the KAGB, and its shares are not securities under the WpPG, the prospectus must still comply with the Investment Asset Act (*Vermögensanlagengesetz*) (VermAnlG) if the shares are distributed in a public offering (that is, not just to professional investors). However, the VermAnlG does also not require a prospectus if, for example, one or more of the following conditions are met:

- No more than 20 shares of the same kind are offered.
- The price of all shares offered within 12 months does not exceed EUR100,000.
- The share price does exceed EUR200,000 per investor.

It is unclear whether a public offering of a duly registered European Venture Capital Fund requires a prospectus. Even if the European Venture Capital Fund qualifies as an investment fund under the KAGB, the KAGB does not have any provisions requiring a prospectus for European Venture Capital Funds. The VermAnlG is also not applicable, because the European Venture Capital Fund qualifies as an investment fund under the KAGB. Unfortunately, the explanatory memorandum of the KAGB does not provide clarification. It cannot be ruled out that BaFin will require a prospectus for European Venture Capital Funds.

11. How is the relationship between investor and fund governed? What protections do investors in the fund typically seek?

Generally, the relationship between the fund and its investor(s) is regulated by the partnership agreement (if the fund is a KG) or the company's articles of association (articles). However, if the VC fund qualifies as an AIF or as a European Venture Capital Fund:

- The articles must also comply with the regulatory requirements of the KAGB or the European Venture Capital Fund Regulation.
- In addition, the relationship between an investor and an AIF or a European Venture Capital Fund is regulated by the investment requirements (*Anlagebedingungen*) which have to be provided for every AIF and European Venture Capital Fund.
- Further, the KAGB and the European Venture Capital Fund Regulation also provide a variety of provisions with a specific impact on the relationship between a VC fund and its investors (*see Question 9*).

Investors commonly seek the following protection:

- Binding investment guidelines, particularly on the portfolio's diversification and the maximum investment term in a target to minimise the risk.
- Provisions safeguarding the fund's tax-efficient structure to avoid double layers of tax, at fund level and at investor level. The fund should be structured so the investors, as limited partners, are treated fiscally as if they have invested directly in the underlying targets. Due to the transparent fund structure, returns are only taxed at investor level. The fund itself is not subject to taxation.
- Information rights, participation rights and certain control rights, for example, defined investment types, or payments on extra management bonuses being subject to prior approval of an advisory board representing the investors.
- Calculable and feasible payment obligations to the fund.
- Regulation of the fund's expenses, particularly on management and performance fees.
- Regulations on the commitment of key personnel or managers, to create confidence in the fund and align the different interest of managers and investors. This is commonly achieved by committing managers and key personnel to invest their personal capital into the fund at a certain percentage (as a rule 1% of the committed capital has to be provided by the fund management).
- Extensive and sufficient exit or disinvestment possibilities from an evergreen-structured fund or, if the fund is closed-ended, regulations on the investment term and conditions concerning a possible extension.

INTERESTS IN INVESTEE COMPANIES

12. What form of interest do venture capital funds take in an investee company?

VC funds take equity interests in the target, often combined with a type of shareholder loan. Recently, a combination of equity investment and mezzanine interests has become common.

Shareholder loans and most mezzanine interests are subject to strict rules on the preservation of equity. A shareholder loan is treated as subordinated debt in insolvency, unless it is granted by non-managing shareholders holding 10% or less of the company's shares. If a shareholder received repayments on a shareholder loan during the period of up to one year before filing for insolvency, these payments can be contested and reclaimed. Security granted for a shareholder loan by third parties can also be reclaimed, if granted within ten years before filing for insolvency.

Due to the restrictions that apply under section 8a of the KStG and section 4h of the EStG, the interest stripping rule (*Zinsschranke*) must be observed when combining equity capital with mezzanine capital or debt. The deduction of interest on borrowed capital is limited to 30% of the taxable earnings before interest, taxes, depreciation and amortisation (EBITDA), if the interest expenses of the company exceed EUR3 million.

VALUING AND INVESTIGATING INVESTEE COMPANIES

13. How do venture capital funds value an investee company?

Early-stage companies are difficult to value because traditional valuation methods such as profit/earning ratios, net present values or discounted cash flows are generally unavailable.

Therefore, a pragmatic evaluation using a market comparison, known as external benchmarking, is commonly used. Evaluation categories have been established based on the company's:

- Area of business.
- Stage of development.
- Previous experience and success of the founders.
- Soundness and maturity of the business plan.
- Commitment of the key business partners.

Early-stage valuation is also based on internal rate of return (IRR), a risk capital interest, which varies according to the technological and commercial market-entry risk. The IRR is calculated based on a formula using the realisable exit value, the investment ratio and the expected target return.

Generally, on exit, a VC fund looks for a multiple of:

- Ten, on investments made at a pre-revenue stage of the company.
- Five, on a revenue-stage business.
- Three, on a business which is about to break even.

However, the valuation applied is subject to commercial negotiations between the investor and the company, and also depends on other external factors, such as the existence of competing offers by other investors.

14. What investigations do venture capital funds carry out on potential investee companies?

VC funds usually conduct thorough due diligence on the target, its business and its managers and other key employees.

Typically, due diligence includes a review of:

- The legal and financial books and records.
- Documents relating to prior financings.
- Customer and supplier contracts.
- Employment contracts.
- Intellectual property rights (IPRs).
- Tax matters.
- Pending or threatened litigation.
- Regulatory compliance.

In technology and life science companies, separate IP research is normally conducted by a firm of specialised patent attorneys to ascertain the status of the company's IPRs.

Any significant negative results from due diligence can lead to the investor deciding against investment. For minor deficiencies, the investor generally insists on resolving them before investment. Minor risks are also generally covered in the representations and warranties given by the company to the investor in the investment agreement.

LEGAL DOCUMENTATION

15. What are the principal legal documents used in a venture capital transaction?

The principal legal documents used are:

- Investment agreement.
- Shareholders' agreement (often combined with the investment agreement).
- The target's articles.
- Service agreements for founders and key personnel.
- Rules of procedure for the supervisory board/advisory board.
- Rules of procedure for the management.

PROTECTION OF THE FUND AS INVESTOR

Contractual protections

16. What form of contractual protection does an investor receive on its investment in a company?

The most common forms of contractual protection for VC investors are:

- **Information rights.** General information rights are provided by the target's articles. However, these rights generally only cover standard information rights for shareholders as a statutory requirement. Additionally, the shareholders' agreement normally requires the management to report to the investor (and other major shareholders) on a monthly, quarterly and annual basis.
- **Control rights.** The investment agreement normally contains a detailed list of business matters requiring the prior consent of the advisory board. The investor is usually granted the right to appoint a certain number of members of the advisory board.
- **Representations and warranties.** In the investment agreement, the company and the founders typically give detailed representations and warranties concerning, among others things:
  - the legal organisation of the company;
  - capitalisation, taxes and financial statements;
  - ownership of assets (particularly IPRs);
  - important commercial agreements;
  - employees;
  - litigation;
  - legal and regulatory compliance.

- **Anti-dilution protection.** Shares issued to the investor usually benefit from anti-dilution protection. Anti-dilution provision aims to protect the investor from economic or formal dilution (due to a lower valuation of the target company), that may occur in subsequent financing rounds. The full-ratchet method grants the original investor the exclusive right to unilaterally subscribe for as many new par value shares as required for him to pay, on average, the same price as the subsequent investor in the down round. The weighted average method takes into account the relationship between the total amount invested before the anti-dilution adjustment and the investment of the new investor.
- **Pay-to-play.** Pay-to-play provisions are regularly included in investment documents when several investors have co-invested in a target, obliging all investors to proportionally participate in subsequent rounds of financing. An investor's failure to fulfil its obligations normally results in a loss of preferential rights such as, for example, the anti-dilution protection.
- **Milestone financing.** To limit the risk of total loss for the investor, particularly when investing in a seed company, the total investment is often split into two or more tranches. Only the first tranche is subscribed for by the investor immediately on signing the investment documentation. The following tranches are only paid if the company has achieved certain clearly defined milestones.
- Liquidation preferences. See *Question 18*.

Forms of equity interest

17. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

To compensate for the high risk VC funds take when investing in early-stage companies, they usually take equity shareholdings with preferred or special rights (in contrast to other jurisdictions, these preferred or special rights typically are not organised as a certain class of shares but provided for in the shareholders' agreement).

Sometimes, investors also subscribe to a bridge loan in the form of a convertible bond, typically in situations where a target needs short-term funding while negotiating a financing round. Once the financing round is closed, the bond is converted into preferred interests, often with a more favourable valuation to reward the investor providing bridge financing for the additional risk.

Preferred shares

18. What rights does a fund have in its capacity as a holder of preferred shares?

Preferred shares usually carry some or all of the following rights:

- Anti-dilution protection.
- Veto rights to block certain extraordinary decisions.
- Information rights.
- Preference in case of liquidation, dissolution, trade sale, merger and IPO. The preference amount is normally equal to the original investment plus interest, but may also be a multiple of the original investment.
- Advisory board representation rights.
- Pre-emptive rights to participate in subsequent financing rounds (*see Question 22*).
- Co-sale rights and rights of first refusal in relation to other investors' and founders' shares.
- Drag-along rights (*see Question 21*).
- Conversion rights, that is, the right to convert the preferred shares held in a stock corporation (*Aktiengesellschaft*) into common shares, or to have the company as a whole convert from a limited liability company into a stock corporation, in connection with certain exit events, such as an IPO.

Management control

19. What rights are commonly used to give a fund a level of management control over the activities of an investee company?

Under tax regulations, the fund cannot directly influence the management of the portfolio company or give instructions to the management board (*Geschäftsführung*). For other means of control and the investor's information rights, see *Question 16*.

Share transfer restrictions

20. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

Generally, both the articles and shareholders' agreement prohibit shareholders from transferring their shares to third parties, unless the shares are first offered for sale to the existing shareholders pro rata to their existing shareholding. However, certain transfers are normally exempt from these restrictions. For example:

- Investors' shares can be freely transferred to affiliates or funds managed or advised by the same investment manager.
- Founders' shares can be transferred to close relatives.

In a permitted transfer, the transferee must assume all rights and obligations of the transferor arising from the investment documents.

21. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company?

Investors are generally protected by drag- and tag-along rights, the effect of which depends on the type of VC fund and the target's specifications.

Drag-along rights force the other shareholders to sell their shares if a certain percentage of the company's shares are to be sold to a buyer. Generally, founders and other existing shareholders try to negotiate a minimum price per share, which must be offered to trigger the drag-along right to avoid a sale of the company in a fire sale, that is, at a low valuation. However, investors ensure that the drag-along right cannot be triggered without their consent. The selling shareholder must ensure that the potential buyer acquires all shares of the other shareholders at the same price and conditions which have been offered to the selling shareholder, otherwise the purchase is prohibited.

Tag-along rights ensure that if the majority shareholder sells its stake, minority shareholders can join the deal on the same terms and conditions that apply to the majority shareholder. Tag-along rights protect minority shareholders, if the majority choose not to exercise their drag-along rights.

Pre-emption rights

22. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

The right to participate in subsequent financings is already granted by law, explicitly for stock corporations and generally recognised for private limited companies, but is also usually included in the investment documentation. Typically, the investor is granted the right to invest at the same conditions as a new investor to maintain its pro rata percentage in the company.

Consents

23. What consents are required to approve the investment documentation?

Typically, the advisory board of the company must approve the investment documentation and authorise the management board to sign it on behalf of the company.

Shareholder approval is required to approve necessary capital increases and required changes to the company's articles.

If there are existing company investors, their approval for the new investment may be required based on the investment documentation of the previous financing round.

COSTS

24. Who covers the costs of the venture capital funds?

The VC fund usually covers the costs of due diligence and legal fees of investors, as well as any notarial and registration fees. Sometimes investors try to shift these costs to the target company. Normally, costs are capped.

FOUNDER AND EMPLOYEE INCENTIVISATION

25. In what ways are founders and employees incentivised? What are the resulting tax considerations?

Incentives

The three major ways of incentivising founders and employees are:

- Variable salary components.
- Equity-related schemes.
- Exit bonus arrangements.

Variable salary components. The variable salary components are mostly linked to the fulfilment of certain key performance targets by the company. They are normally granted in the respective employee's service agreement. Income from variable salary components is fully taxed as employees' wage income and may be deducted as expenses by the company.

Equity-related schemes. Equity-related schemes consist either of direct grants of shares in the target itself (for example, through performance equity ratchets) or the grant of share options. Since the classification of shares earned through performance ratchets as wage income, performance equity ratchets have become less popular.

Share options (mostly on ordinary shares) are commonly granted as warrants or convertible bonds, and mostly vest over a period of up to four years. Normally, share option schemes provide for accelerated vesting in a successful trade sale or IPO of the target during the general vesting period.

Exit bonus arrangements. Often, management is additionally incentivised by an exit bonus arrangement. The exit bonus may consist of:

- Payment of a fixed bonus on exit.
- A percentage of the proceeds in case of a trade sale or an IPO.
- The grant of share options which are exercisable in case of an exit.

Depending on the specific structure of a VC fund the remuneration of the founders and employees may also be regulated by the AIFM Directive and the KAGB. The particular effects of this on the remuneration require a case-by-case examination.

Tax

Variable salary components. Income from variable salary components is fully taxed as employees' wage income and may be deducted as expenses by the company.

Equity-related schemes. In relation to equity-related schemes, options are normally not taxed on issue, but on exercising the option. The difference between the value of the shares at the time of exercise and the strike price is fully taxed as wage income.

In the unlikely case of dividend payment during investment, the dividends are taxed according to the partial income system (*Teileinkünfteverfahren*) under section 3(40) of the EStG. This means that 40% of the dividends are tax free if the employee holds at least 1% of the company's share capital and opts for this treatment (that is, the personal income tax rate (which normally ranges from 14% to 45%) applies to the taxable part (60%) of the dividends). If the employee does not opt for this treatment, a flat tax of 25% (plus solidarity surcharge and eventual church taxes) applies.

Capital gains from the sale of company shares are also taxed under the partial income system, provided the employee holds at least 1% of the company's share capital. If the employee holds less than 1%, a 25% flat tax (plus solidarity surcharge and eventual church taxes) is applied.

If the partial income system applies, costs related to the dividends are also deductible by 60% (under the flat rate, taxation deduction of these costs is not possible, besides a certain general amount exempt from tax).

Before 1 January 2009, capital gains from share sales of a participation of less than 1% held for more than one year were tax exempt. This exemption has been abolished but still applies to participations acquired before 1 January 2009 (due to transitional rules).

Exit bonus arrangements. Benefits for the employee arising out of exit bonus arrangements are fully taxed as wage income.

26. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture?

The most common ways to ensure that founders and other key employees remain with the company are:

- Share options that vest over several years.
- Compulsory transfer of founders' shares if a founder leaves the company (negative vesting).
- Post-contractual non-competition agreements.

Compulsory transfers are generally incorporated in the articles as redemption rights of shares, and in the shareholders' agreement as call options for the other shareholders. The percentage of shares subject to the compulsory transfer provision normally decreases over time (negative vesting). While bad leavers are often only paid the nominal value of the shares transferred, good leavers often receive compensation close to fair market value.

Non-competition agreements for more than three years from departure are likely to be held invalid. Compensation of at least 50% of final salary must be paid to the founder if this is provided in the founders' service agreement.

EXIT STRATEGIES

27. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

The most common forms of exit are:

- Sale of the company to the company's management.
- Sale of the company to another investor.
- Sale of the company's assets to one or more third parties.
- Liquidation or insolvency.

Although secondary sales of whole portfolios of VC investments have recently become popular, the majority of exits from an unsuccessful target are by liquidation or insolvency (exit by exodus). A sale of the company or its assets allows the investor to receive at least part of its investment. In liquidation, the company must satisfy all of its debtors, before making any distributions to its shareholders. The liquidation procedure is time consuming due to the extended publication periods.

28. What forms of exit are typically used to realise a venture capital fund's investment in a successful company? What are the relative advantages and disadvantages of each?

The following forms of exit are typically used to realise an investment in a successful company:

- Trade sale.
- IPO.
- Secondary buyout.

Trade sale

This is the most common form of exit. It allows investors to exit immediately and completely. The investor is normally in control of the process, and can extract maximum value in negotiations with the buyer. However, key employees may be concerned about the change of ownership. A trade sale can also involve business risks for the company, particularly when the potential buyer is a competitor.

IPO

This is the preferred form of exit for management since they generally remain in control of company operations. An IPO also gives the investor the opportunity to achieve higher returns if the value of the company's shares increases after the IPO. However, the investor is not normally allowed to sell its shares at the time of the IPO, since both investors and key personnel are required to agree to a lock-up of their shareholding for at least six months after the IPO. In addition, an IPO normally involves greater risks, since capital markets, particularly for high-tech companies, are volatile. The process takes much longer than a trade sale and is normally more costly.

Secondary buyout

Recently, secondary buyouts have become a more frequent form of exit. This method has the advantage of being less dependent on the climate of capital and financial markets, which influence opportunities for trade sales and IPOs. It also gives the investor the chance to realise its investment earlier, while the company still has potential for further development. However, the multiples realised in a secondary buyout are normally lower than in an IPO or a trade sale to a strategic investor.

29. How can this exit strategy be built into the investment?

The investor should try to obtain a clear commitment from all parties involved that they will co-operate to achieve an exit as soon as practicable. The investment documentation should support this commitment by including the following:

- Drag-along provisions (*see Question 21*).
- Tag-along provisions (*see Question 21*).
- Liquidation and trade sale preferences which are triggered by mergers and acquisitions, and may even be extended to cover an IPO (*see Question 18*).
- Control rights which give the investor veto rights over the type and timing of the exit (*see Question 16*).
- Restrictions on the sale of founders' shares to incentivise them to aim for a trade sale or an IPO (*see Question 20*).
- Conversion rights (*see Question 18*).

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Recent transactions

- Representing a venture company of a global group in relation to the participation in a Luxembourg fund.
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Publications

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- Advice on a public offering of a corporate bond, drafting of the securities prospectus and guidance on capital market authority (BaFin) proceedings.
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Publications

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