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MARKET

1. Please describe briefly the venture capital market in your jurisdiction, in particular:

- **How it is distinguished from private equity.**
- **The sources from which early stage companies obtain funding.**
- **The types of companies that attract venture capital investment.**
- **Market trends (for example, levels of investment, the type of companies invested in and where those companies are located).**

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. When contrasted 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 2009, the group of investors for early-stage VC investments were divided as follows (*German Private Equity and Venture Capitalist Association (Bundesverband Deutscher Kapitalbeteiligungsgesellschaften) (BVK) Statistics for 2009*):

- Financial institutions: 31%.
- Funds of funds: 11%.
- Private investors: 9%.
- Insurance companies: 6%.
- Pension funds: 4%.
- Industrial companies: 4%.
- Other asset managers: 3%.

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 perspective.

VC investment targets in 2009 were mainly in the industrial and high-tech sectors including:

- Corporate and industrial services: 16.9%.
- Corporate and industrial products: 16.6%.
- Computer and consumer electronics: 16.5%.
- Life sciences: 12.8%.
- Communication technology: 10.8%.
- Consumer products and trade: 8.1%.
- Energy and environment: 3.8%.

More than half of all targets have fewer than 100 employees. Only 12% of targets employ more than 100 people.

Market trends

VC investment in early-stage companies held up in the first quarter of 2010, compared to figures from the first quarter of 2009, although it was still negatively affected by the financial crisis (*BVK, quarterly statistics*). In the first quarter of 2009, EUR79 million (as at 1 November 2010, US$1 was about EUR0.7) were invested in early-stage VC (increasing to EUR85 million in the first quarter of 2010).

Later-stage VC investment amounted to EUR34 million in the first quarter of 2009 and significantly increased in the first quarter of 2010 up to EUR46 million. The first quarter of 2010 therefore demonstrated an increase of 35% in investment volume compared to the first quarter of 2009. The number of financings also increased sharply from 209 to 271.

Although the effects of the financial crisis have not yet been overcome, the VC market is returning to normal. However, it is far from matching the recovery seen in private equity as a whole (which has seen a six-fold increase from its lowest point).

The regional focus of VC investment slightly changed in 2009:

- 22% in Bavaria (24% in 2008).
- 14% in Baden-Wuerttemberg (19% in 2008).
- 10% in Schleswig-Holstein (8% in 2008).
- 9% in North Rhine Westphalia (10% in 2008).

TAX INCENTIVES

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

Most VC investors are not subject to a specific regulatory regime, but fall under the general legal and regulatory requirements, particularly for VC taxation.

The Act for the Promotion of Venture Capital Participations (*Wagniskapitalbeteiligungsgesetz*) (WKBG) introduced tax incentives and forms part of the Act on the Modernisation of Framework Conditions for Venture Capital and Equity Investments (*Gesetz zur Modernisierung der Rahmenbedingungen für Kapitalbeteiligungsgesellschaften*) (MoRaKG). The MoRaKG included minor changes to the:

- Trade Tax Act (*Gewerbesteuergesetz*) (GewStG).
- Corporate Income Tax Act (*Körperschaftssteuergesetz*) (KStG).
- Personal Income Tax Act (*Einkommensteuergesetz*) (EStG).

These changes mean that 60% of carried interest is now taxable (previously 50%) (that is, 40% of the carried interest is tax free).

Private investors (business angels) that provide risk capital receive a tax benefit of up to about EUR22,500 on the capital gain realised in the sale of their participation. This benefit stems from changes to the EStG implemented by the MoRaKG. However, the European Commission (Commission) ruled 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)*) that these provisions are incompatible with EU law unless the Commission's recommended amendments are made. The Commission ruled that some provisions of the MoRaKG are incompatible with the Risk Capital Guidelines and the principle of freedom of establishment, since VC companies must be domiciled in Germany to profit from the MoRaKG's tax incentives. It remains to be seen how the German government will react (*see Question 11*).

Under the current regime, companies recognised by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) (BaFin) as VC investment companies (*Wagniskapitalbeteiligungsgesellschaften*) profit from an exception to the limit on loss deductibility (*section 8c, KStG*). Tax losses carried forward and current tax losses are forfeited completely or partly if shares in the corporation are transferred. If more than 25%, but no more than 50%, of shares are acquired the tax losses are extinguished pro rata. For example, if 30% of shares are acquired, 30% of tax losses are extinguished.

If a VC investment company acquires more than 50% of the shares in a target, the tax losses are forfeited entirely. This also applies under certain other conditions, for example, if a VC investment company subsequently disposes its shares to a third party or if a capital increase in the target company leads to a change in the participation quota.

Although there is no longer a special exception for VC companies, in some cases one of the other (general) exceptions can be applicable, in particular:

- Under the restructuring provision of section 8c, paragraph 1a of the KStG, the restrictions on deductibility of tax losses (*see above*) are not applicable if, among other requirements, the VC investment aims to prevent the target from insolvency and preserves its essential structures. However, by notice of the Commission from 24 February 2010, the restructuring provision of section 8c, paragraph 1a of the KStG is incompatible with EU law and the German government has decided not to apply this provision before the Commission makes a final decision.
- Tax losses carried forward and current tax losses can be preserved in the hidden reserves of the target in Germany (completely or partly, according to the percentage of shares transferred).

FUND STRUCTURE

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

There are three major groups of VC investors (*BVK Statistics 2009*), listed in size order:

- Credit institutions, for example, public or semi-public investment companies of public financial institutions such as the federal state banks (*Landesbanken*), municipal saving banks (*Sparkassen*), the state-owned Development Loan Cooperation (*Kreditanstalt für Wiederaufbau*) (KfW).
- Independent funds and managing funds of institutional and private investors (funds of funds).
- Corporate venture capital companies (CVC) of major industrial companies that invest in high-tech companies to achieve strategic additional value besides financial success.

Venture capital investments are generally regarded as supplementary investments by institutional investors, because of the:

- Current tax scheme.
- Stringent requirements to be recognised as a VC investment company by the BaFin.
- Profit from the tax incentives introduced by the MoRaKG.

Compared to other VC markets, pension funds are generally not involved in VC funding. Only 0.26% of institutional investment capital is invested into VC and 1.3% into private equity investments generally (*study by Fleischhauer, Hoyer & Partner Private Equity Consultants on behalf of the German Federal Ministry of Economy, January 2008 (BMWi Study)*).

Private individuals, particularly high net-worth individuals and family offices play a significant role in the VC market. About one-third of VC funds administer private investors' capital (*BMWi Study*).

75% of VC fund managers prefer private individual investors as they are more flexible concerning the portfolio strategy of the fund.

Surveys on the private equity market generally show reluctance from institutional investors to invest in private equity in times of financial crisis.

4. Can the structure of the venture capital fund impact on how investments are made?

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

Under 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.

The optional election of a fund to be treated as one of the two categories that are specifically regulated (*see Question 6*) and special provisions accompanying election can influence the way investments are made.

5. 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 companies (*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, a VC fund can only invest in five to ten targets, with a limited possibility to diversify and minimise risk, if the fund does not co-invest.

FUND FORMATION AND REGULATION

6. What legal structure(s) are most commonly used as vehicles for venture capital funds in your jurisdiction?

The most common legal structure for VC funds is the private limited partnership (KG) with at least one general partner whose liability is unlimited. Usually, the general partner is a private limited company (*Gesellschaft mit begrenzter Haftung*) (GmbH) and the investors are the limited partners. For tax reasons, a second GmbH normally acts as a managing limited partner.

Only two categories of VC/private equity funds are specifically regulated:

- Equity investment companies (*Unternehmensbeteiligungsgesellschaften*) licensed under the Equity Investment Companies Act (*Unternehmensbeteiligungsgesetz*) (UBGG).
- VC investment companies licensed under the WKBG.

The UBGG and WKBG regulate funds' organisation and capital structure rather than legal form.

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:

- Pursue the object of purchasing, keeping and selling company shares (*Unternehmensbeteiligungen*) in terms of equity capital under section 1, paragraph 1a of the UBGG.
- Be located within Germany.
- Have a minimum share capital of EUR1 million.

There are currently about 80 equity investment companies. VC investment companies have not yet been established under the WKBG.

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

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

The legal structures for VC funds do not require licensing. In 2008, the Federal Administrative Court (*Bundesverwaltungsgericht*) (BVerwG) ruled (contrary to the BaFin's legal opinion) that a limited partnership investing in financial instruments does not conduct a finance commission business (*Finanzkommissionsgeschäft*) requiring a licence under the Banking Act (*Kreditwesengesetz*) (KWG).

A VC investment company must be licensed by and listed with the BaFin.

To be recognised as a VC investment company by the BaFin, a company must:

- Pursue the object of purchasing, keeping and selling venture capital investments (*Wagniskapitalbeteiligungen*) in terms of equity capital (*section 2, paragraph 2, WKBG*).
- Be located in Germany.
- Have a minimum share capital of EUR1 million.
- Be managed by at least two qualified individuals subject to a separate registration at the BaFin.

Although the WKBG does not introduce a comprehensive tax regime, establishing a VC investment company under the WKBG has tax implications (*see Question 2*).

On 30 April 2009, the Commission issued a draft Directive on Alternative Investment Fund Managers (draft AIFM Directive). The draft AIFM Directive applies to all AIF managers (irrespective of the legal structure of the AIF, whether the AIF is domiciled inside or outside the EU, and closed- or open-ended), which are both:

- Above a certain asset value (EUR100 million including leverage or EUR500 million without leverage, and with no exercisable redemption rights for five years).
- Established in the EU, providing management services to AIF or market shares or units to professional investors (as defined under Council Directive 2004/39/EC on markets in financial instruments (MiFID).

Even if the asset value does not exceed these thresholds, certain registration and disclosure duties must be met by AIF managers.

Under the draft AIFM Directive, AIF managers must:

- Fulfil certain authorisation standards.
- Submit regular, at least yearly asset valuations.
- Comply with:
  - conduct of business rules;
  - capital and transparency requirements.

The draft AIFM Directive was passed by the European Parliament on 11 November 2010 and will become effective on 1 January 2011. EU member states must then implement the AIFM Directive into national law within two years, leading to a comprehensive set of supervision rules for VC fund managers.

8. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions? Include, in the answer, any restrictions on how a venture capital fund can be marketed or advertised (for example, under private placement or prospectus rules).

Generally, domestic VC funds do not qualify as investment companies under the Investment Act (*Investmentgesetz*). However, foreign VC funds can, depending on their corporate structure, qualify as foreign investment companies.

If shares in a VC fund are publicly offered in Germany, the offering requires a prospectus, which must be approved by the BaFin.

A prospectus must comply with the Sales Prospectus Law (*Verkaufsprospektgesetz*) if the shares do not qualify as securities but are distributed in a public offering (that is, not only to professional investors) and one or more of the following applies:

- The share price does not exceed EUR200,000 per investor.
- More than 20 shares of the same kind are offered.
- The price of all offered shares within twelve months exceeds EUR100,000.

If the participations qualify as securities and are distributed in a public offering, the prospectus must comply with the Securities Prospectus Law (*Wertpapierprospektgesetz*).

Since unregulated VC funds are commonly structured as limited partnerships (*see Question 4*), participations in these funds do not generally qualify as securities. Consequently, a prospectus for an offer in Germany of participation rights in an unregulated German VC fund is generally only required if the additional conditions (distribution through a public offering and minimum capital commitment less than EUR200,000) under the Sales Prospectus Law are met.

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

Generally, the relationship between the fund and its investor(s) is regulated by the partnership agreement (if the fund is a limited partnership) or the company's articles of association (articles). 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 conceivable 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.
- Extensive and sufficient exit or disinvestment possibilities from an evergreen-structured fund (that is, with an unlimited holding period), or, if the fund is closed-ended, regulations on the investment term and conditions concerning a possible prolongation.

10. What are the most common investment objectives of venture capital funds (for example, what is the average life of a fund, what return will a fund be looking for on its investments and what is the time frame within which a fund would seek to exit its investment)?

Closed-ended VC funds generally have a maximum holding period of ten years. However, some funds are evergreen (*see Question 9*). 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 of the European top quarter of VC funds is 13.6%. German VC funds have an average rate of return of 5%, with the top German VC averaging at 23%. However, these figures demonstrate 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).

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

Recent changes were introduced by the MoRaKG (*see Question 2*). The German government's reaction is now anticipated following Decision 2010/13/EC that tax incentives for investors contained in the MoRaKG contravene European law. Given that VC investment companies under the WKBG have not been widely accepted by the market, it is likely that the MoRaKG will be considerably amended. Although the Federal Government and the Bundestag have not yet reacted to the Commission's decision, it is possible that not only will tax incentives be amended, but also the approval and registration requirements for VC investment companies.

The AIFM Draft Directive will require national implementation, under which VC fund managers will be subject to a comprehensive set of supervision rules (*see Question 7*).

INVESTOR PROTECTION

12. What form of investment do venture capital funds take? (For example, equity, debt or a combination.)

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 conservation 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 in a time of crisis 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 during a time of crisis can also be reclaimed, if granted within ten years before filing for insolvency. Since young innovative companies are usually considered to be in a time of crisis, shareholder loans given by the VC fund often hold no advantage over direct equity investment.

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.

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 is also dependent on other external factors, such as the existence of competing offers by other investors.

14. What investigations will 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.

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.

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 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*.

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 generally take equity interests with preferred or special rights. 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 shares, often with a more favourable valuation to reward the bridge financing investor for the additional risk.

18. What rights does a fund have in its capacity as a holder of preferred shares (for example, what rights to capital and/or to interest)?

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.
- Co-sale rights and rights of first refusal in relation to other investors' and founders' shares.
- Drag-along rights.

- 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.

19. What rights are commonly used to give a fund a level of management control over the activities of an investee company (for example, board representation, certain acts of the company subject to investor consent)?

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 information rights for the investor, see *Question 16*.

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 (for example, drag-along and tag-along rights)?

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 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.

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 generally 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.

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.

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

The VC investment company usually covers the costs of due diligence and legal fees of investors, as well as any notarial and registration fees. Normally, costs are capped.

FOUNDER AND EMPLOYEE INCENTIVISATION

25. In what ways are founders and employees incentivised (for example, through the grant of shares, options or otherwise)? What are the resulting tax considerations?

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 recently 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.

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 Personal Income Tax Act (*Einkommensteuergesetz*) (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 42%) 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% (whereas, under the flat rate taxation a 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

Often, management is additionally incentivised by an exit bonus arrangement. The exit bonus may comprise:

- 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.

These benefits arising out of this arrangement for the employee 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 (for example, good leaver/bad leaver provisions and restrictive covenants)?

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.
- 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 in the founders' service agreement.

EXITS

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 (for example, trade sale, initial public offering and secondary buyout)? 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 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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