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Venture Capital – Quo Vadis? How to Invest Successfully as a Business Angel

In Germany, the term Venture Capital (“VC”) was originally used for all types of investments that were considered Private Equity and Venture Capital in the United States of America. These days, the German term Venture Capital stands for financing by private capital in young, non-listed, technology-oriented enterprises in their early stage and growth phases.

The status of early-stage financing of technology companies in Germany

Even if a significant increase in start-up activities has been noticeable in the years following the period of disillusionment from 2001 to 2005, start-up teams are still trying to find adequate financing options. In fact, the current funding by public investors like High-Tech Gründerfonds and Bayernkapital does not suffice to promote innovation nationwide.

Nowadays, due to their size, VC funds have to invest approximately EUR 2 to 5 million per target. Thus, any investment within the range of EUR 0.5 to 1 million will have to be funded by Business Angels in cooperation with public co-investors. In addition to the capital, Business Angels contribute their expert know-how to the start-up and unlike VC funds, Business Angels are not bound by stringent investment criteria. They often cooperate with other Business Angels or public co-investors. Besides benefitting from the German public fund “Wagniskapital”, Business Angels also receive wide support by the European Union through the European Angel Fund that is partially funded by German taxes.

Business Angels and VC funds (“Investors”) usually fund a company for an unrestricted investment period on a long-term horizon; the financing is all equity

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without any leverage instruments. The investment always aims for high value of the company leading to a high exit multiple.

The essential characteristics of start-ups in order to qualify for funding

One basic requirement is a stable – not only regionally orientated – business model. Investors will in particular analyze the business model focusing on the following areas as part of a due diligence:

- Business
- Financial
- Legal
- Human Resources

It is important for the founders to present themselves as a cohesive team having the ability to act goal-oriented and having the will and strength to implement changes during inevitably occurring stressful periods. Lone wolves as founders often have difficulties to build trust and confidence with the Investors. They are sometimes even rejected by Investors, as nobody is superman.

Personal investment or investing through an investment company?

Business Angels invest in young technology businesses either in person or through their holding company (*Beteiligungsgesellschaft*) such as a German limited entrepreneurial company (*UG – Unternehmergesellschaft, haftungsbeschränkt*), a German limited liability company (*GmbH – Gesellschaft mit beschränkter Haftung*) or a German stock corporation (*AG – Aktiengesellschaft*). When using a corporation (*Kapitalgesellschaft*) as holding company, such a company will benefit from a significant tax deferral effect, since the participation exemption rules (*Schachtelprivileg*) pursuant to Sec. 8b para. 2 of the

German corporation tax act (*KStG – Körperschaftsteuergesetz*) results in a tax exemption amounting to up to 95% of the exit proceeds received by the holding company. However, if the holding company distributes funds to the Business Angel as its shareholder – instead of reinvesting the funds in other ventures – the Business Angel will be taxed according to the partial income method (*Teileinkünfteverfahren*) or with the settlement tax (*Abgeltungssteuer*), respectively.

However, an initiative of the German Ministry of Finance is currently jeopardizing this very profitable form of Angel Investments by considering abrogating Germany's participation exemption rules (*Schachtelprivileg*). Earlier attempts by German federal states, for example most recently by the Minister of Finance of the federal state of Hesse, Dr. Schäfer, to abrogate the participation exemption rules (*Schachtelprivileg*), were rejected explicitly by the Federal Government and the Parliament due to the positive effect of Angel Investments on entrepreneurship. The office of the German Chancellor as well as the general political opinion has yet to comment on the new initiative of the Ministry of Finance.

DOs and DON'Ts for Venture Capital-like Angel Investments

■ Establishment

After having worked out a business plan and having entered into a binding commitment to implement such business plan, the founders should establish their company as a corporation (*Kapitalgesellschaft*) without any Investor being invested at that early stage. Subsequently, the Investors should participate in the company in financing rounds (*Finanzierungsrunden*) by subscribing newly created shares of the company – not by buying existing shares of the founders. Practical experience shows that the following scenarios should be avoided: The founders establish the company together with the Investors of the first financing round or the Investors establish the company and the founders participate in the company at a later stage with shares/stocks or options of the company. Both scenarios cause considerable payroll tax deficits for the founders as well as for the Investors.

If the founders have been working jointly on their start-up idea prior to the establishment of the company and have organized themselves as a “de facto” company (for example a German company constituted under civil law (*GbR – Gesellschaft bürgerlichen Rechts*)), they should not terminate or liquidate their previous company and thus evoke the impression that prior to the newly incorporated GmbH no research and development activities (R&D) had taken place. This can have a negative effect and may lead to hesitation among the Investors.

■ Contractual agreements in accordance with founders’ and investors’ concerns

Successful Angel investments benefit from VC-suitable structures within the company. This includes the following contractually agreed rights of the Investors as minority shareholders: Entitlement to appoint advisory and/or management board members, veto or approval rights as regards shareholders’ resolutions on important company issues a majority requirement ensuring the Investors’ influence as well as a liquidation preference, anti-dilution protection, drag-along/tag-along-rights and a founders’ lock-up. Besides the contractual provisions, a fair relationship of the Investors and founders is especially important. Thus, Investors should pay attention to not diluting the founders’ shares too quickly. Usually Investors initially purchase 10-30% of the company’s shares, depending on their investment. However, it is common for the Investor to receive a customary liquidation preference for a minority investment in case of an exit. The disadvantages for minority shareholders under corporate law will of course be compensated by the contractual arrangements, so that it does not make sense to insist on other options on the threshold of 25% or 50% respectively for a shareholding in the company.

The Investor’s rights can be even more secured by veto-rights or. The relationship between Investors and founders will benefit if the Investors identify tax risks for the founders and avoid such risks in the investment structure.

■ Term sheet

To start the investment process, future Investors and the founders should determine the key conditions in a term sheet. By doing so, they will find a common

basis for the investment before the Investors start to trigger costs by involving third parties for the due diligence process. Moreover, the founders can focus on an exclusive group of investors and put on hold or finish talks with other Investors. Most of the clauses of a typical venture capital term sheet are not binding. These are in particular:

- Investment volume
- Number of shares/percentage of participation
- Company assessment (pre-money and post-money valuation)
- Milestone clause
- Investor's rights (liquidation preference, anti-dilution, put-options, tag-along, drag-along)
- Founders' lock-up and vesting-clause
- Establishment of the advisory board and appointment of members
- Transactions requiring approval
- Reporting requirements
- Conditions for the conclusion of final and binding contracts

On the other hand, the following clauses of the term sheets are almost always binding:

- Confidentiality
- Exclusivity
- Costs

■ Investment Agreement

The investment agreement (*Beteiligungsvertrag*) is the basis of each investment by an Investor in the company. Thus, if the Investor is supposed to acquire new shares/stocks, the founders and other shareholders will be obliged under the investment agreement to decide on a capital increase and to grant the respective subscription rights to the Investor. Hence, the Investor will receive the agreed number of shares/stocks, usually preferred shares/stocks (*Vorzugs-geschäftsanteile/Vorzugsaktien*), as consideration for his investment. If the company is a GmbH, a notary public must notarize the investment agreement.

Notarization may incur extra costs depending on the company's valuation and actual investment volume. Regarding the investment agreement of an AG, there is no need for notarization. A written investment agreement signed by all parties will suffice. A notary public must always notarize the shareholders' resolution for a capital increase. This applies to both the GmbH and the AG.

The investment agreement covers all arrangements relating to the acquisition of the shares/stocks, for example the amount of the Investor's contribution to the capital reserve (*sonstige Zuzahlung in die Kapitalrücklage*), arrangements concerning the installment payments and milestones, valuation adjustment by the founders in case of failing to reach the milestones, warranties of the founders as well as the legal consequences in case of a breach of a warranty of the founders (*Garantieverletzungen der Gründer*). Usually, as a consequence of a warranty breach, the founders will be obliged to resolve a compensatory capital increase in favor of the Investors, so that the Investor will receive additional shares/stocks as a compensation for the breach of a warranty instead of a cash compensation.

Often the Investors will also revise the employment agreements of the founders. If the start-up company has no advisory board (*Beirat*) at the time of the investment, an advisory board will be established. Following the establishment of the board, bylaws for the management (*Geschäftsordnung für die Geschäftsführung*) and bylaws for the advisory board (*Geschäftsordnung für den Beirat/Aufsichtsrat*) should be adopted in order to strengthen the position of the Investors regarding their right to be heard and to a say.

■ Shareholders' Agreement

While the investment agreement includes the terms and conditions for the Investors' investments in the company, the shareholders' agreement (*Gesellschaftervereinbarung*) covers the details of the long-term cooperation between the Investors and the founders. The shareholders' agreement contains, in contrast to the articles of incorporation, all arrangements that shall be kept confidential, since the articles of incorporation (*Satzung*) are published in the German commercial register (*Handelsregister*) and are thus open to inspection by everyone. Besides the advantage of confidentiality, the shareholders' agreement of an AG

can always be amended without the requirement of notarization. But all shareholders being party to the shareholders' agreement must participate in the amendment, which is disadvantageous compared to an amendment of the articles of incorporation being possible with a $\frac{3}{4}$ majority. Newly joining shareholders are automatically bound by the articles of incorporation, whereas they have to join the shareholders' agreement by explicit declaration (*Beitrittserklärung*). A shareholders' agreement typically contains the following clauses:

- Voting pool agreement concerning the election of the advisory/supervisory board members
- Voting pool agreement, or restriction of the voting rights in the shareholders' meeting and veto-rights
- Anti-dilution protection
- Liquidation preference
- Drag-along and tag-along
- Founders' lock-up/vesting

■ Articles of Incorporation

The articles of incorporation usually cover the relationship of the shareholders amongst each other and to the company. The articles of incorporation may contain provisions on the classifications of the shares/stocks in different share-/stock-classes, granting different rights to the shareholders like, for example, the liquidation preference. Furthermore, transfer restrictions for shares/stocks (*Verfügungsbeschränkungen/Vinkulierung*), redemption of shares/stocks (*Einziehungsrecht*) and the appointment of board members (*Entsendungsrechte*) are generally standard clauses and part of the articles of incorporation. In addition, Investors may be granted more influence by changing the legal majority requirements (*Mehrheitserfordernisse*) for important decisions in the shareholders' meeting.

Summary

The funding of young, non-listed, technology-oriented companies in the seed and growth phases by VC – in particular by Angel Investments – is essential for

promoting innovation. With Angel Investments, young companies benefit not only from the Investor's capital but also from the Investor's personal expertise. Besides contractual agreements, a fair relationship between the Investors and founders is very important.

The German public Fund "Wagniskapital" as well as the EU European Angels Fund "Angel-Investments" support Angel Investments. To date, Business Angels holding a minority stake in a start-up benefit from the German participation exemption rules (*Schachtelprivileg*) of Sec. 8b para. 2 KStG, as long as they invest through a German corporation (*Kapitalgesellschaft*) as holding company (*Beteiligungsgesellschaft*). However, the German Ministry of Finance has initiated a process for the abolition of the German participation exemption rules, leaving the future of Business Angel Investments uncertain. Considering the positive effect of Angel Investments on innovation and entrepreneurship, one can only hope that the tax benefit for Angel Investments is not changed for the worse, and that the framework conditions as agreed in the German coalition contract will be implemented.

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