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Germany

VENTURE CAPITAL

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This country-specific Q&A provides an overview of venture capital laws and regulations applicable in Germany.

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GERMANY
VENTURE CAPITAL

1. Are there specific legal requirements or preferences regarding the choice of entity and/or equity structure for early-stage businesses that are seeking venture capital funding in the jurisdiction?

When starting any early-stage business, the business form not only creates the legal framework for subsequent entrepreneurial activity, but also influences, among others, tax and accounting obligations, the founding formalities and the way investors or banks assess the company. A basic distinction is made between partnerships and corporations. Partnerships are characterized by the fact that they can be set up easily and with little bureaucratic and financial effort. Since a partnership is an association of individuals, the founding members are, however, basically liable with their private assets which is one of the reasons that partnerships are the exception within the German venture capital environment. Another reason is that the participation of an investor, which itself is structured as a tax transparent investment fund, in a partnership might also negatively impact the tax status of such investor. In contrast, a limited corporation is only liable with its assets. The German limited liability company (*Gesellschaft mit beschränkter Haftung*) with a required share capital of at least EUR 25,000.00 is the most frequently chosen corporation form in Germany. The main advantage is the limited liability of the individual shareholders. The founders (and shareholders) are therefore not liable with their private assets if the company suffers difficulties, but only in the amount of the capital contribution or the amount of the company's assets. In addition, such legal form simplifies the collaboration with external investors as the share capital is split in transferable shares with a nominal value of EUR 1.00 each. The entrepreneurial company (*Unternehmergesellschaft (haftungsbeschränkt)*) is not a separate legal form, but a special form of the Germany limited liability company. The advantage compared to a classic Germany limited liability company is that the required share capital amounts to EUR 1.00 only. Founders knowing from the start that they will raise large amounts of funding in the future or pursue an initial public offering may consider to set up their company as a German stock corporation (*Aktiengesellschaft*). However, in Germany a stock cooperation involves from scratch increased organizational and legal efforts for the founding team. In addition, the share capital of a German stock cooperation is at least EUR 50,000.00.

2. What are the principal legal documents for a venture capital equity investment in the jurisdiction and are any of them publicly filed or otherwise available to the public?

In connection with a venture capital financing, the investment agreement, the shareholders' agreement and the articles of association form the core documentation. The investment and shareholders' agreements create the basis for the investor's financial investment and participation in the respective company and consist of two independent parts, the investment agreement, which contains the agreements on the investor's financial participation in the start-up. up, as well as the shareholders' agreement, which regulates the future cooperation between the founding shareholder(s) and investor(s) as (future) shareholders of the company. The two parts are either combined into one agreement or concluded as two separate agreements. If the target is a German limited liability company in the legal form of a GmbH the signing of the investment documentation requires notarization by a public notary which incurs substantial costs depending on the investment sum. With respect to the company's articles of association, the independent regulatory content of the articles of association is limited because the material commercial and legal agreements between the founding shareholder(s) and venture capital investors are regulated in the investment and shareholders' agreement. Therefore, only those provisions having mandatory corporate law character are typically included in the company's articles of association. Nevertheless, the articles of association are

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a mandatory part of every venture capital investment documentation as it is necessary to align the articles of association with the investment and shareholders' agreement. Furthermore, accompanying documents such as for example managing director service contracts, rules of procedure for the management and/or an advisory board and agreements on (virtual) employee incentive schemes are regularly negotiated in the course of a venture capital funding. With regard to publication requirements the investment and shareholders' agreement (and the other accompanying documents) do (unlike the articles of association) not have to be published in the company's commercial register. Therefore, the respective regulations contained in investment and shareholders' agreement remain confidential and cannot be reviewed by third parties.

3. Is there a venture capital industry body in the jurisdiction and, if so, does it provide template investment documents? If so, how common is it to deviate from such templates and does this evolve as companies move from seed to larger rounds?

In Germany, there exists no specific venture capital industry body comparable, for example, to the National Venture Capital Association in the US. There exist certain private initiatives providing publicly available template documentation for the foundation and (seed) funding rounds. However, predominantly the investment documentation is still set up individually by the lawyers based on their standards.

4. Are there any regulatory frameworks in respect of companies offering shares for sale that need to be considered, for example any restrictions on selling and/or promoting the sale of shares to the general public?

Basically not, unless the issuance of shares is (exceptionally) subject to the German Investment Code (K*apitalanlagegesetzbuch (KAGB)*). In addition, there may be specific restrictions depending on the company's respective field of activity, e.g. according to the German Governance Banking Act (*Kreditwesengesetz (KWG)*) which may need to be considered for fintech companies.

5. Are there any general merger control, anti-trust/competition and/or foreign direct investment regimes applicable to venture capital investments in the jurisdiction?

Venture capital investments are in this regard no different from other (M&A / financing) transactions that are regulated in Germany. Seed and early-stage venture capital transactions are in general due to their size not subject to anti-trust/competition law and merger control. If venture capital transactions, in which for example state venture capitalists, venture capital investment vehicles of large industrial companies and/or business angels with many investments participate, exceed the relevant turnover thresholds according to the German Act against Restraints of Competition (*Gesetz gegen Wettbewerbsbeschränkungen (GWB)*) then those transactions are subject to merger control by the Germany the Federal Cartel Office.

The review of foreign direct investments has become more important over the past years, also in Germany. Some foreign investments are subject to closer scrutiny, especially in sectors such as critical infrastructure, defence and sectors otherwise considered relevant for the national security or public order. Those foreign investments in relevant sectors are subject to review by the Federal Ministry for Economic Affairs and Energy. Relevant transactions may – in certain cases – be void until cleared.

Having an eye on these topics and complying with the relevant regulations is therefore essential for the effective planning and structuring of venture capital transactions in order to prevent the invalidity of the transaction and/or material fines.

6. What are the prevailing tax incentives or structures offered to venture capital investors in the jurisdiction, if any?

In Germany, in relation to venture capital investments, no specific industry related tax incentives or structures apply to investors. For the targets themselves, on the other hand, there exist tax advantages and initiatives.

7. What is the process, and internal approvals needed, for a company issuing shares to investors in the jurisdiction and are there any related taxes or notary (or other fees) payable?

A share capital increase first requires an effective shareholders' resolution in which the specific capital increase is resolved upon, i.e. in particular the amount by which the share capital is increased. When adopting

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the resolution, the statutory requirements for the form (notarization) and the required majorities (qualified majority of at least 75% of the votes cast) must be complied with. In addition, further requirements in the company's articles of association may apply. The existing shareholders of the company are generally entitled to a subscription right in the event of the capital increase in order to have the opportunity to maintain the same participation before and after the capital increase. After the above-mentioned shareholders' resolution the company and the respective subscriber will sign a certified subscription form (*Übernahmeerklärung*). Subsequently, the subscriber is obliged to pay the issue price (i.e. the nominal amount of (in general) EUR 1.00 per share) for the respective newly issued shares. After the payment of the nominal amount(s) for the subscribed shares the company's managing directors(s) will apply for the registration of the capital increase with the company's commercial register. With the respective approval and registration of the capital increase in the company's commercial register, the capital increase becomes effective and further additional investment obligations (associated with the subscribed shares) will become due and payable. As the capital increase resolution as well as the signing of the investment and shareholders´ agreement requires notarization substantial notary fees will be triggered. Specific taxes (such as stamp duties) do not apply when subscribing to newly issued shares within a venture capital transaction.

8. How prevalent is participation from investors that are not venture capital funds, including angel investors, family offices, high net worth individuals, and corporate venture capital?

Over the last few years the participation of corporate venture capitalists in the venture capital ecosystem, following a global trend, has increased significantly. There exist several hundred corporate venture capital companies actively investing in Germany. Reasoning behind is a win-win situation for both the investor and the target. The CVC gets access to technology and know-how, the founders have a reliable partner ideally being the exit-partner at a later point in time. AI, aerospace, and green / clean tech, among others, predominate sector-wise.

German family offices, in the past, slowly adopted venture capital as an alternative asset class mainly because of a traditionally risk-averse investment strategy. Predominantly family offices invest into the venture capital fund itself and become a limited partner. However, recently, the number of family offices making direct venture capital investments has increased. Certain family offices prefer to split their venture capital distribution between direct investments and managed funds.

In terms of angel investors, those play, since the establishment of the German venture capital ecosystem, always an important role. In many cases in Germany business angels are themselves experienced entrepreneurs providing their know-how and access to their network in return for an investment at a relatively low valuation. The main difference to venture fund investors is the timing of the investment: angel investors support startups at a very early stage and are more involved in the development phase. The lower valuation of their investment is combined with a higher risk to fail.

It remains to be seen if CVCs, family offices and other non-traditional investors will, in 2024, continue to expand their participation in venture capital in a world of higher interest rates and political uncertainties.

9. What is the typical investment period for a venture capital fund in the jurisdiction?

Typically, venture capital funds have a lifetime of 7 to 10 years. Evergreen funds are the exception within Germany. Most companies take at least 4 to 5 years and often more to reach a scale that will attract a purchaser and provides for a substantial return to the investors. Therefore, venture capital funds build up their main portfolio within the first 3 to 4 years after setting up the fund and the typical investment period ranges between 3 to 6 years.

10. What are the key investment terms which a venture investor looks for in the jurisdiction including representations and warranties, class of share, board representation (and observers), voting and other control rights, redemption rights, anti-dilution protection and information rights?

As part of the investment agreement, the key investment terms relate to (i) the company's current valuation, its underlying calculation (typically on a fully diluted basis) and the stipulation of the investor's specific investment amount and preferred share class, (ii) an independent title and business guarantee catalogue and corresponding legal consequences to claim monetary damages and (iii) anti-dilution protection rights (varying from broad based to full-ratchet). As part of the shareholders' agreement, each (or a group of) investor(s) – or a supervisory body (usually an advisory

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board), the members of which are primarily chosen from the venture capital investor group – will reserve approval requirements and protective provisions for certain structural measures (e.g. further capital increases, establishment of further share classes and the like) or management actions as investors generally only subscribe to a minority stake in the company. Those approval rights typically do not apply to the company's ordinary business operations but rather to those actions having a significant financial or structural influence on the company. In addition, a venture capital investor will secure its investment by specific (revolving) information, reporting, exit and disposal rights (e.g. lock-up, tag- and drag-along rights). The core commercial element of the shareholders' agreement is the liquidation and proceeds preference based on which (exit) proceeds will be distributed among the shareholders. Common standard in Germany is the principle "last in, first out" whereby the prevailing liquidation preference mechanism (in the last years) is a one-time non-participating preference (*einfache anrechenbare Erlösverteilungspräferenz*) which primarily serves as down-side protection.

11. How common are arrangement/ monitoring fees for investors in the jurisdiction?

Except for limited director´s fees for serving on the (advisory board) of a target arrangement or monitoring fees for investors are uncommon in Germany.

12. Are founders and senior management typically subject to restrictive covenants following ceasing to be an employee and/or shareholder and, if so, what is their general scope and duration?

Typically, founders and – if required by the investor(s) – specific key employees of the company are subject to a post-contractual non-competition and non-solicitation restriction, which prevents the respective persons from (directly or indirectly) using their specific know-how in a way that is detrimental to the company's business. The imposed prohibitions usually apply for the duration of up to two years after the relevant individual ceased to be an employee and/or shareholder of the company, but in each case restricted in subject matter and location to the field in which the company is involved at the time of the withdrawal. In case of an infringement of the prohibitions, the respective individual typically will have to pay a contractual penalty and/or will have to transfer parts of his shares in the company. However, the possession of shares in rivalling enterprises (e.g. if shares are held for investment purposes only and do not permit any influence on the executive bodies of the rivalling enterprise) may be excluded from the non-compete obligation subject the parties' individual agreement.

13. How are employees typically incentivised in venture capital backed companies (e.g. share options or other equity-based incentives)?

The incentivisation of employees is typically achieved through their participation in implemented employee incentive program(s) enabling the respective beneficiary's economic participation in the company's future value increase. In Germany, the issuance of virtual shares (i.e. contractual payment claims instead of real shares) is common practice because the subscription for virtual shares will not immediately trigger tax obligations at the time of issuance ("no dry income"). Furthermore, those virtually incentivised employees will have no actual shareholder rights which makes the organizational handling of the program easier, in particular if the employee leaves the company.

However, on December 18, 2023, the German Future Financing Act (*Zukunftsfinanzierungsgesetz (ZuFinG)*) entered into force which shall (inter alia) ultimately prevent the beneficiary from being burdened with tax in connection with the issuance of real shares at the time of issuance. Therefore, it remains to be seen whether virtual shares will in future still predominate the employee incentivisation within the German venture capital environment.

14. What are the most commonly used vesting/good and bad leaver provisions that apply to founders/ senior management in venture capital backed companies?

Within commonly used vesting provisions, the respective founder or employee undertakes to transfer his (directly or indirectly) held shares to the company or the other shareholders subject to the occurrence of specific (leaver) events and to conclude relevant purchase and assignment agreements. The number and the equivalent value of the shares to be transferred is regularly determined based on the time and/or reason for the resignation and/or termination of the respective concerned individual (so called "bad leaver" or "good leaver" events) whereby the most commonly used vesting period amounts to forty-eight months with a linear monthly vesting and a one year cliff. In general, a founder is considered to be a "good leaver" if the company terminated or removed the concerned

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individual from his position as managing director without good cause (*ohne wichtigen Grund*). In addition, a "good leaver" case typically also exists if the concerned individual terminates or resigns for good cause (*mit wichtigem Grund*) for which the company is responsible for. Conversely, a person is considered to be a "bad leaver" if the respective (employment) relationship or office ends for good cause (*aus wichtigem Grund*) for which the respective person is responsible for or if the concerned person terminates or resigns without good cause (*ohne wichtigen Grund*). The legal consequences following the respective leaver event are usually a core point of negotiations within a venture capital transaction. In case of a bad leaver event the concerned individual is typically obliged to transfer all of its shares for a consideration of the respective shares' nominal value. In case of a good leaver event, the unvested part of the shares is usually transferred for a consideration of the respective shares' nominal value and the vested part of the shares remains with the concerned individual.

15. What have been the main areas of negotiation between investors, founders, and the company in the investment documentation, over the last 24 months?

As a consequence of the previous and current market uncertainties it was and is becoming apparent that target companies are assessed with lower valuations which leads to in-depth negotiations of the transaction's underlying commercial terms. From a legal perspective, it can be noticed that the framework conditions relating to liquidation preference and down round protection were the main areas of negotiation whereby the investors' negotiation position increased in strength over the last twenty-four months. Participating liquidation preferences and full-ratchet anti-dilution protection are on the rise again.

16. How prevalent is the use of convertible debt (e.g. convertible loan notes) and advance subscription agreement/ SAFEs in the jurisdiction?

In Germany, the use of convertible loan agreements is clearly the prevailing form of financing instruments in order to raise capital in a fast and cost-efficient manner without having to (immediately) carry out a notarized capital increase. However, also SAFEs (Simple Agreements for Future Equity) are on the rise and are now becoming more popular in the German venture capital environment. However, in Germany SAFEs are (unlike convertible loan agreements) still subject to specific legal uncertainties due to a lack of relevant legal literature and pertinent case law. Thus, it can be expected that convertible loan agreements will remain predominant when it comes to short-term venture capital financing in Germany.

17. What are the customary terms of convertible debt (e.g. convertible loan notes) and advance subscription agreement/ SAFEs in the jurisdiction and are there standard from documents?

In general, the basic provisions of convertible loan agreements and SAFEs relate to the same underlying mechanism according to which the investor provides the company with capital in return for the (future) opportunity to subscribe for shares in the target. In short, a SAFE is a cash deposit combined with the option to subscribe for shares in the target whereas a convertible loan agreement is a standard loan combined with a contractually agreed right for conversion. Convertible loan agreements have a fixed term of (as a general rule) up to two years. In contrast, a SAFE regularly runs for an indefinite period of time. In the context of convertible loan agreements, the company as borrower has to pay a certain interest on the loan amount depending on the current interest rate environment. With SAFEs, no interest is usually agreed on the investment amount. The right to ordinary termination is generally excluded for convertible loan agreements. This does not affect the possibility of terminating the contract for good cause. SAFEs, on the other hand, usually do not provide for the possibility of termination. In the context of convertible loan agreements, there are various scenarios (upcoming financing rounds, the occurrence of an exit or expiry of the fixed term) that lead to a conversion of the loan amount. In each case, a unilateral right of the investor or the company or a bilateral right or a general obligation to convert is subject to negotiations in each particular case. In comparison, SAFEs stipulate that an issue of shares must be made in the next financing round that follows the conclusion of the SAFE. Furthermore, caps and discounts and "most favoured nation" clauses are typically agreed upon in convertible loan agreements and SAFEs.

18. How prevalent is the use of venture or growth debt as an alternative or supplement to equity fundraisings or other debt financing in the last 24 months?

Venture debt in Germany can still be described as a niche existence compared to the classic venture capital

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equity financing. In the last twenty-four months there was only a relatively small amount of venture debt deals whereby the recent collapse of the Silicon Valley Bank is likely to have caused some temporary uncertainty in that regard. However, considering the overall development of venture debt in the German venture capital ecosystem, a steady market growth can be observed. The driver of this long-term market growth was an increasing demand for venture debt in Europe, as the number of start-ups financed by institutional venture capital investors and reaching later growth phases with higher financing requirements have increased noticeably over the past years. Given the current environment of rising interest rates and high macroeconomic volatility, the challenges for start-ups on the venture capital market will remain high and venture debt will continue to be in demand as a complementary source of financing (in particular prior to an exit as the venture debt will not dilute the shareholders´ participation in the company). The continuous development of venture debt offers appears to be an important prerequisite that the still young German venture debt market continues to make an increasing contribution to improving the German venture capital financing environment.

19. What are the customary terms of venture or growth debt in the jurisdiction and are there standard from documents?

In Germany, the main documentation for venture debt financing mainly consists of the actual loan agreement. In addition, there may be a separate warrant agreement and other security agreements (relating for example to global assignments, account pledges or other security transfers). Venture debt contracts are increasingly based on standard documents provided by the Loan Market Association and regularly contain the following key provisions: Interest payment and implementation of equity kickers which provide to the lender a share in the positive economic development of the company. The remaining contractual provisions are largely comparable to regular bank loans. The disbursement of the loan is subject to specific conditions, in particular that the agreed securities are provided. The creditworthiness of the company is confirmed by representations and warranties as of the respective signing date and is secured by several covenants applying during the loan's term. Obligations to cease and desist and financial indicators (covenants) are secured. If the borrower violates a covenant, a representation turns out to be incorrect and/or a payment default occurs, this will create an event of default and an accompanying extraordinary termination right for the lender. In order to secure the lender's information about the company's (financial) situation and to monitor the compliance with the covenants, the lender usually receives regular reporting on the company's financial situation and, if necessary, is also entitled to delegate an observing member to the company's advisory board (as the case may be).

20. What are the current market trends for venture capital in the jurisdiction (including the exits of venture backed companies) and do you see this changing in the next year?

A key trend in the German venture capital market remains the focus on technology startups. Germany has a strong reputation for innovation and technological advancements and investors are keen to capitalize on this. As a result, there has been a lot of activity in funding targets in the fintech, greentech, edtech and healthcare sectors. Furthermore, there is a growing trend of international investors, particularly from the United States and Asia, to invest in Germany. In this regard Germany benefits from a robust venture capital ecosystem. Accompanying the German government started initiatives to back the startup ecosystem (e.g. through grants, pari-passu co-investments and tax incentives for employees). This background makes Germany an attractive investment place for both of national and international investors.

While Germany saw a record of 21 unicorns in 2023, the pace is expected to slow down this year. Rising interest rates, geopolitical tensions and politics of pandemic recovery replaced the previous years' strong appetite for investments leading to a large number of investors reducing their capital commitments. Therefore, in 2023 a declining level of deal activity compared to the records set in 2021/22 can be observed with the consequence of investors and entrepreneurs stockpiling funds and cutting costs. Despite a lot of dry powder in the market investors seem to be more cautious and mitigate risks by favouring early-stage deals over late-stage deals as those are less vulnerable to market swings.

When it comes to the fluctuation of valuations another observation is that the average pre-money valuations for late-stage investments significantly dropped whereby the valuations for early-stage investments remained constantly high.

In recent years the targets and their founders set the pace for financing rounds – with regularly short deadlines and quick steps towards the completion of financing rounds. Nowadays venture investors take over again the determination of the cornerstones of a transaction process and are less guided by (sometimes

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artificially set) short deadlines than in the past.

It can be expected that, as opposed to 2023, the due diligence process will be of more importance again. Greater care in the due diligence process will impact the timeline of transactions. This will likely lead to the fact that growth companies will have to rely more frequently on interim and bridge financing – for example through convertible loans or the extension of existing financing rounds without additional investors.

The returned weight of venture capital funds is also reflected in greater negotiating power towards the startups and their founders when it comes to transaction documentation. In particular more frequent venture investor friendly provisions in the liquidation preference (i.e. the preferential distribution of proceeds in an exit event) will rise. Also structuring rights (such as forcing an exit by exercise of drag along rights), anti-dilution protection and protective provisions (thresholds, veto rights etc.) will shift more in favour of venture investors than in the recent past.

While the German economy is forecast to grow next year, factors such as high inflation and weak consumption continue to weigh heavily on the financial markets. In this context the exit activity of venture capital backed companies has declined sharply in 2023. There have been significantly fewer trade sales and IPOs of growth companies than in the past and the venture capital backed exit values decreased; almost returning to pre-2021 levels.

However, the venture capital sector has always been characterized by its proximity to innovative technology-driven and disruptive business models. Many tech companies owe their success to the support of venture capital funds. This symbiosis between technology and venture capital will continue in Germany. In view of current macro trends such as digitalization, sustainability and demographic change and the capital requirements associated therewith the areas green/clean tech, AI, healthcare and aerospace, among others, promise to be particularly dynamic.

Viewed positively, the developments in 2023 and the first quarter of 2024 may be seen as an overdue correction after which venture capital financings in Germany soon will regain momentum with new dynamic and focus on profitable business models. Although presumably deal counts and valuations will not immediately rise again, it can be assumed that the venture capital market will shortly pick up pace again as Germany continues to foster innovation and entrepreneurship.

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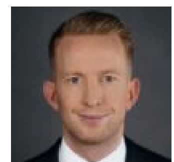

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