A quick guide to VC investment in Germany

By Robin Eyben

I t won’t come as a surprise to readers of this column that the German venture capital market is much smaller than that of the U.S. But while U.S. VC activity appears to be in the middle of a self-correction period, the German venture market almost doubled in the first two quarters of 2017 compared with the same period in 2016. With a number of indicators showing that this trend is set to continue, it is worth looking at what makes Germany an attractive market for VC investment.

Why Invest in Germany?

A number of promising developments in the German market provide VC investors, including U.S.-based VCs, with strong incentives to diversify their portfolio by investing in German startups. On the one hand, Germany boasts excellent infrastructure, increasing the availability of co-investments through public funds and a highly-skilled workforce (consisting of engineers and developers particularly) supplying labor for comparatively lower salaries. The German market is considerably more investor-friendly due to valuations of German startup companies that are generally lower than their Silicon Valley counterparts.

Legal and regulatory incentives also abound, including the deductibility of tax losses for VC funds, a strong protection for intellectual property and a tax exemption of 95 percent of proceeds from divestment in German startups or exits (provided certain requirements are met).

These developments and incentives have not gone unnoticed as evidenced by the increase in U.S.-based VC funds investing in Germany. But what should U.S. VCs know about investing in Germany? While the VC investment process generally follows U.S. standards, there are a number of legal, structural and practical differences that are worth explaining.

Process and Implementation of a Financing Round

The GmbH (German: Gesellschaft mit beschränkter Haftung — limited liability company) is the choice of legal form for the vast majority of venture-backed emerging and growth companies in Germany — similar to the Delaware Corporation in the U.S.

VCs often finance Delaware Corporations by purchasing shares of preferred stock of such corporations. A VC financing of a German GmbH is accomplished by a capital increase and the issuance of new preferred shares in the GmbH to which the VC subscribes. Whereas in the U.S., Delaware General Corporate Law requires the authorization of additional shares of stock and their sale and issuance to be approved by a corporation’s board of directors, in Germany, the capital increase requires a shareholders’ resolution to be adopted by at least 75 percent of the votes cast.

In a further deviation from Delaware General Corporate Law — and this is one of the more idiosyncratic features of German corporate law — capital increases and share issuances, sales, and transfers, adoption of and changes to its bylaws (referred to as articles of association), each require notarization and registration in the local public commercial register.

The notarial deed form requires the representatives of the shareholders and the company to be physically present in front of a German civil notary for the reading of the entire notarial deed (called ‘investment agreement’). As cumbersome as this notarial process may seem, the transaction documentation is usually agreed upon and final prior to the notary appointment, meaning the appointment itself is attended by a limited number of representatives (often authorized by powers of attorneys).

Following the signing of the notarial deed, the company’s investors are required to pay to the company the nominal amounts of the shares issued to them (typically €1 per share) and into the capital reserves of the company the investment funds exceeding the nominal amounts.

Venture Capital Documentation and Terms

While German legal due diligence and negotiations on the definitive transaction documentation also begin with the signing of a term sheet with a VC investor, experienced German founders often prefer a more detailed description of the deal terms than their U.S. counterparts and require the governing law of the transaction documents to be German and to follow German market standards. Note that in principle this is not detrimental to the interests of the investor as German law provides clarity and transaction security to the parties when governing the mechanics of the financing and share issuance of a German entity, however, one should be aware of the substantive differences the choice of German market standards vs. U.S. market standards entails.

The three most substantive differences in VC terms between U.S. transactions and German transactions are as follows:

1. German deal documentation often includes representations and warranties that contain limitations typically seen only in M&A transactions in the U.S., such as caps on liability and survival periods. On the other hand, in Germany, in addition to the company, founders are also typically required to make representations and warranties regarding operational aspects of the company such as those related to financials, litigation, public permits, intellectual property, employees, material contracts and tax). The founders making such representations and warranties are also subject to personal liability which is capped for each founder at an amount that is equal to double or triple the annual salary such founder earns for serving as a managing director or employee of the company.

2. Tag-along rights are granted to all shareholders, including the founders, in the majority of German VC deals while in the U.S. commonly only investors are entitled to co-sale rights.

3. With regard to control terms, German investors often require more control and a larger catalogue of protective provisions than would be the case in U.S. deals. For example, a common German protective provision requires consent of the investor or the majority of preferred shares to any tran-
actions outside the ordinary course of business, including entry into any agreements that result in liabilities of the company that exceed a certain threshold.

‘Flips’

Finally, it is worth noting that under certain circumstances, it may be beneficial for a German GmbH to be ‘flipped’ into a Delaware c-corporation. In such flip transactions, often the GmbH is maintained as a fully-owned subsidiary of the Delaware c-corporation, which allows it to continue to employ German-based employees and to hold intellectual property which can be further developed by the German R&D staff while being fully licensed to the U.S. parent. A flip, however, requires due consideration and a thorough review of the intellectual property structure and the tax impact resulting from the choice of the entity that will own it, the latter of which, if it is negative, should be weighed carefully against the benefits of a flip, in particular the prospect of higher valuations in follow-on rounds, a larger pool of investors and acquirers and access to U.S. public markets.

Conclusion

VC investments in German startups currently represent a tremendous opportunity for U.S. investors to take advantage of the lower valuations of German startups and the tax advantages enjoyed in connection with exit events. Given the differences enumerated in this article, which, due to space constraints does not address every aspect, difference in law, difference in process, and other pieces of information that may be relevant to a decision to invest in a German startup, a VC is best advised to use experienced legal counsel trained in both jurisdictions for cross-border U.S./German financing transactions. In addition to securing the right counsel to represent the investor in a cross-border transaction, the successful planning, negotiation, and implementation of investments in German startups, as well as awareness of the key aspects of applicable German law and its differences from U.S. law is also the responsibility of the U.S. investor, with those who are better prepared and better informed are also naturally more likely to realize positive returns on their investments than those who are not.

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