



# Legal Dos and Don'ts When Startups Raise Money



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Christian Wyss, Attorney at Law, Partner

Gian-Andrea Caprez, Attorney at Law, Managing Associate



# Creating a Niche Market

- Can we get patents or other intellectual property rights?
- Who owns these rights and how to transfer them to the startup?
- Will we get an exclusive market position by setting standards and being first on the market?
- Market potential
- Freedom to operate



# Potential Investors

- Friends, Family, Fools
- Non-dilutive funding
  - Grants
  - Foundations (Wellcome Trust, Bill and Melinda Gates Foundation)
  - Prize money
  - Government led programs (CTI, PATH, NIH, ERC)
- Business Angels
- Family Offices
- Seed Funds
- Venture Funds
- Corporate Venture Funds
  - Pharma, Insurance, Telecom



## A New Actor Enters the Play

- Dilution
- New members of the board of directors
- Information rights
- Increased reporting and compliance burden

# ● Corporate Housekeeping

- Recommendations
  - Establish and maintain a share register and a register of beneficial ownership (mandatory)
  - Make sure all share transfers are properly documented (chain of title of shares is mostly an issue in any later transaction)
  - Make sure that all the corporate documents (original of share register etc.) are stored centrally
  - Issuance of share certificates depends on the circumstances



# Legal Due Diligence

- Keep your agreements neatly ordered!
  - Parties
  - Signatures
  - Exclusivity and antitrust issues
  - Provisions giving sole discretion to one party
  - Termination possibilities
  - Changes of control and assignment
  - Annexes



# Exit Scenarios

- IPO
- Trade Sale
- (exclusive) license or partnering agreements
- Management Buy-Out
- Sale of future income or royalty streams



## Progress in Business or in Fundraising?

- Temporarily re-allocate its resources from operations to financing
- BUT: quality and credibility of the management, good business practice, stable financial planning, reasonable valuation, realistic revenue hypothesis, realistic and attractive exit plan and scalable business model
- Commitment of the founder team





# Financing Round

- Debt or equity?
  - Pros loan: easy repayment and interest expenses reduce taxable profits → both rather irrelevant for startups  
No dilution (or dilution occurs later)  
No discussion on valuation
  - Cons loans: risk of over indebtedness, hidden equity (thin capitalization rules) → interest may not be deducted, withholding tax issues
- Debt: bridge loan or convertible loan
- Equity: capital increase or transfer of shares

# ● Debt: Bridge Loan or Convertible Loan

- General: subordinated (junior) to other obligations or debt
- Bridge Loan: must be repaid
- Convertible Loan: conversion at a discount of 10% to 20% at following financing round
- Conversion rights must be backed by conditional capital or irrevocable commitment of shareholders

# ● Equity

- Transfer of Shares
  - Selling or reallocating shares from the **founders** as such does not bring funds to the company. Additional steps will be required (loan, à-fonds-perdu contribution, employment agreement, etc.)
- Capital Increase
  - **Company** issues additional shares for a subscription price per share equal or higher than the par value



## Investment Process (4 to 9 months)

- Contact investors, send teaser
- Send non-confidential business plan
- Sign confidentiality agreement
- Q&A session by phone or videoconference
- Exchange of confidential business plan and documents of major interest to investors
- Meet in person, negotiate pre-money valuation
- Due diligence
- Negotiate (and sign) term sheet

# ● Investment Process (4 to 9 months)

- Draft investment and shareholders agreements
- Review and negotiate investment and shareholders agreements
- Prepare annexes and closing documentation (articles of incorporation, public deeds for capital increase, etc.)
- Signing
- Closing
- Registration with register of commerce
- Issuance of new share register (and share certificates)

# Capitalization Table

Hockey Stick GmbH Share Capital Table January 2016						
Shares	Total Issued			Total Fully Diluted		
Shareholders	Numbers of Shares	CHF Amount	%	Number of Shares	CHF Amount	%
CEO	80	8'000.00	40%	80	8'000.00	34.78%
CTO	80	8'000.00	40%	80	8'000.00	34.78%
John Doe	20	2'000.00	10%	20	2'000.00	8.70%
Business Angel	20	2'000.00	10%	20	2'000.00	8.70%
			0%	0	0.00	0.00%
			0%	0	0.00	0.00%
			0%	0	0.00	0.00%
			0%	0	0.00	0.00%
			0%	0	0.00	0.00%
<b>Total issued shares</b>	<b>200</b>	<b>20'000.00</b>	<b>100%</b>	<b>200</b>	<b>20'000.00</b>	<b>86.96%</b>
Options	Total Issued			Total Fully Diluted		
Optionees	Number of Shares	CHF Amount	%	Number of Shares	CHF Amount	%
University	10	1'000.00	33%	10	1'000.00	4.35%
Miller Consulting	5	500.00	17%	5	500.00	2.17%
			0%	0	0.00	0.00%
			0%	0	0.00	0.00%
			0%	0	0.00	0.00%
			0%	0	0.00	0.00%
			0%	0	0.00	0.00%
			0%	0	0.00	0.00%
<b>Total Granted</b>	<b>15</b>	<b>1'500.00</b>	<b>50%</b>	<b>15</b>	<b>3'000.00</b>	<b>6.52%</b>
<b>Not Granted</b>	<b>15</b>	<b>1'500.00</b>	<b>50%</b>	<b>15</b>	<b>1'500.00</b>	<b>6.52%</b>
<b>Total Options</b>	<b>30</b>	<b>3'000.00</b>	<b>100%</b>	<b>30</b>	<b>4'500.00</b>	<b>13.04%</b>
<b>Total Fully Diluted</b>	<b>230</b>	<b>23'000.00</b>	<b>100%</b>	<b>230</b>	<b>24'500.00</b>	<b>100.00%</b>

# Capitalization Table

Hockey Stick GmbH Share Capital Table January 2016																				
Incorporation							Seed Financing Round							Series A Financing Round						
Shareholder	Total Issued			Total Fully Diluted			Shareholder	Total Issued			Total Fully Diluted			Shareholder	Total Issued			Total Fully Diluted		
Shareholders	Number of Shares	CHF Amount	%	Number of Shares	CHF Amount	%	Shareholders	Number of Shares	CHF Amount	%	Number of Shares	CHF Amount	%	Shareholders	Number of Shares	CHF Amount	%	Number of Shares	CHF Amount	%
CEO	30	3'000.00	40%	30	3'000.00	34.78%	CEO	30	3'000.00	27%	30	3'000.00	24.24%	CEO	30	3'000.00	16%	30	3'000.00	14.41%
CTO	30	3'000.00	40%	30	3'000.00	34.78%	CTO	30	3'000.00	27%	30	3'000.00	24.24%	CTO	30	3'000.00	16%	30	3'000.00	14.41%
Jahn Das	20	2'000.00	10%	20	2'000.00	8.78%	Jahn Das	20	2'000.00	7%	20	2'000.00	6.06%	Jahn Das	20	2'000.00	4%	20	2'000.00	3.60%
Business Angel	20	2'000.00	10%	20	2'000.00	8.78%	Business Angel	20	2'000.00	7%	20	2'000.00	6.06%	Business Angel	20	2'000.00	4%	20	2'000.00	3.60%
			0%	0	0.00	0.00%	Seed Capital Fund	100	10'000.00	33%	100	10'000.00	30.30%	Seed Capital Fund	100	10'000.00	20%	100	10'000.00	18.02%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%	Venture Capitalist	200	20'000.00	39%	200	20'000.00	36.04%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%	University	10	10'000.00	2%	10	10'000.00	1.80%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%				0%	0	0.00	0.00%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%				0%	0	0.00	0.00%
Total issued shares	200	20'000.00	100%	200	20'000.00	86.96%	Total issued shares	300	30'000.00	100%	300	30'000.00	90.91%	Total issued shares	510	60'000.00	100%	510	60'000.00	91.29%
Options	Total Issued			Total Fully Diluted			Options	Total Issued			Total Fully Diluted			Options	Total Issued			Total Fully Diluted		
Optionees	Number of Shares	CHF Amount	%	Number of Shares	CHF Amount	%	Optionees	Number of Shares	CHF Amount	%	Number of Shares	CHF Amount	%	Optionees	Number of Shares	CHF Amount	%	Number of Shares	CHF Amount	%
University	10	1'000.00	33%	10	1'000.00	4.35%	University	10	1'000.00	33%	10	1'000.00	3.03%	Employee A	5	500.00	6%	5	500.00	0.90%
Miller Consulting	5	500.00	17%	5	500.00	2.17%	Miller Consulting	5	500.00	17%	5	500.00	1.52%	Miller Consulting	5	500.00	6%	5	500.00	0.90%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%	Key Opinion Leader	5	500.00	6%	5	500.00	0.90%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%	Employee B	5	500.00	6%	5	500.00	0.90%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%	Employee C	5	500.00	6%	5	500.00	0.90%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%	CEO	15	1'500.00	18%	15	1'500.00	2.70%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%				0%	0	0.00	0.00%
			0%	0	0.00	0.00%				0%	0	0.00	0.00%				0%	0	0.00	0.00%
Total Granted	15	1'500.00	50%	15	3'000.00	6.52%	Total Granted	15	1'500.00	50%	15	3'000.00	4.55%	Total Granted	40	4'000.00	47%	40	8'000.00	7.21%
Not Granted	15	1'500.00	50%	15	1'500.00	6.52%	Not Granted	15	1'500.00	50%	15	1'500.00	4.55%	Not Granted	5	1'500.00	6%	5	1'500.00	0.90%
Total Options	30	3'000.00	100%	30	4'500.00	13.04%	Total Options	30	3'000.00	100%	30	4'500.00	9.09%	Total Options	85	5'500.00	53%	45	9'500.00	8.11%
Total Fully Diluted	230	23'000.00	100%	230	24'500.00	100.00%	Total Fully Diluted	330	33'000.00	100%	330	34'500.00	100.00%	Total Fully Diluted	595	65'500.00	100%	555	69'500.00	100.00%

# ● Capitalization Table

- Relevant parameters:
  - Total share capital
  - Classes of shares
  - Number of shares
  - Par value → no fractional shares for investors
- Crucial tool to determine how much shares the investors should obtain and control founders' dilution
- Important to align majority requirements in shareholders agreement with actual shareholdings / balance of power
- Facilitates determining the size of the option pool needed to incentivize employees



# ● Legal Documentation

- The SECA venture capital model documentation
  - <http://www.seca.ch/Templates/Templates/VC-Model-Documentation.aspx>
- An excellent starting point to familiarize with the legal documentation for financing rounds (term sheet, investment agreement, shareholders agreement)
  - <http://www.ycombinator.com/documents/>
  - [http://member.cofounderslab.com/templates?utm\\_medium=social&utm\\_source=email](http://member.cofounderslab.com/templates?utm_medium=social&utm_source=email)
  - <https://500.co/kiss/>



# Term Sheet

- Contains important issues of both the investment agreement and the shareholders agreement
- Distinguish between binding and non binding clauses
- Binding are usually:
  - Binding / non-binding agreement
  - Governing law and jurisdiction
  - Exclusivity
  - Reimbursement of due diligence and legal costs

# ● Transaction Structure

- Preferred shares or common shares?
- One time payment or staggered financing?
- Milestones:
  - Issue additional shares when milestone achieved
  - Issue all shares immediately and à-fonds-perdu contribution when milestone achieved



# Investment Agreement - Summary

- Company agrees to increase share capital by issuing additional shares
- Investors agree to subscribe to new shares and pay the agreed subscription price
- Closing mechanics: conditions for executing all or part of the above
- Representations and warranties



# Investment Agreement - Milestones

- Clear definition of milestone that can be understood by judges who are not industry experts
- Time limit
- Absence of material adverse change
- Who decides?
  - Party
  - Board
  - Independent expert
  - Court or arbitration panel
- Has the company a right to claim the milestone payments (even in bankruptcy) or just the shareholders?

# ● Investment Agreement – Reps/Warranties

- Who gives the reps and warranties?
  - Company and/or
  - Founders and/or
  - Other existing investors
- Fundamental reps: organisation and existence of company, title to shares, capitalization
- Business reps: financial statements, tax, social security, employment, assets, IP rights, material contract, litigation, insurance

# ● Investment Agreement – Reps/Warranties

- Remedies: cash, compensatory capital increase, and/or transfer of shares by founders
- Limitation of liability: CHF amount for cash, investment amount for compensatory capital increase, % of shares for transfer of shares

# ● Shareholders Agreement - Summary

- Board composition
- Qualified consent requirements
- Information rights
- Anti-dilution protection
- Preference rights
- Transfer restrictions
- Employee incentive plan
- (Non-compete)
- (Bad leaver provisions or reverse vesting)



# ● Shareholders Agreement - Board Composition

- Founders' representative
- Common shareholders' representative
- Investor directors
- Independent members, independent chairman
- Will executive founders be allowed in the board?



# Shareholders Agreement

## Qualified Consent Requirements

- Avoid: %-thresholds that change the balance of power when just a few additional shares are issued (ESOP (employee stock option plan), anti-dilution, extension of financing round)
- Better: define subject matters that need consent by founders/common shareholders and subject matters that need consent by investors/preferred shareholders
- Hire/fire/change compensation or job description of founders as executives
- When to exit?



# Shareholders Agreement

## Qualified Consent Requirements

- Particularity delicate issues:
  - Hire/fire/change compensation or job description of founders as executives
  - Change ESOP (employee stock option plan)
  - Milestone achievement
  - Requirements for forcing an exit
  - Transactions with related persons



# Shareholders Agreement - Liquidation Preference

- Calculation of preference amount: investment amount plus interest rate or multiple of investment amount
- Do preferred shareholders just get their money first or do they get money in addition to the common shareholders (double dip)?
- If no double dip: preferred shareholders can convert into common shares
- Different waterfalls may apply if proceeds are modest, medium, or abundant (e.g. 1x preference amount, up to 5x preference amount, more than 5x preference amount)



### 3. Questions?

# ● Your contact at VISCHER

Christian Wyss, LL.M.

Partner/Co-Head Startup Desk

[cwyss@vischer.com](mailto:cwyss@vischer.com)

Phone: +41 58 211 33 39



Gian-Andrea Caprez, LL.M.

Managing Associate/Co-Head Startup Desk

[gcaprez@vischer.com](mailto:gcaprez@vischer.com)

Phone: +41 58 211 34 27

