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ORRICK LEGALNINJA SERIES

FLIP IT RIGHT

US HOLDING STRUCTURES FOR GERMAN START-UPS

SET-UP / TAXES / SAFE FINANCINGS AND MUCH MORE

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orrick

VC & TECH BRIEFINGS GERMANY

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ORRICK LEGALNINJA SERIES

About the Orrick Legal Ninja Series – OLNS

In substantially all of the major world markets, we have dedicated technology lawyers who support young German technology companies on their growth trajectory through all stages. As one of the top tech law firms in the world, we are particularly committed to bringing the American and German entrepreneurship ecosystems closer together.

For this purpose, we launched the Orrick Legal Ninja Series ("**OLNS**") back in 2019. With this series, we provide overviews on current legal trends and take deeper dives on certain legal topics particularly relevant for German start-ups and their investors.

OLNS editions are co-authored by a multidisciplinary team of lawyers from our national and international offices. It is our goal to tap into the rich reservoir of the venture capital, corporate venture capital and technology know-how of our international platform and make it available to the exciting German entrepreneurship and innovation scene.

Why "Ninja Series?" This title might simply reflect the fact that some of us watched a little too much TV in the 1990s. But, seriously, "Ninja" has come to signify "a person who excels in a particular skill or activity." That's what the Orrick team strives for when it comes to providing tailored advice to growing tech companies and their investors. We hope that OLNS also empowers you to be a Ninja entrepreneur.

If you'd like to discuss further, please contact us. We would love to learn about your experiences with the topics discussed in this publication, so please share them with us. We constantly strive to evolve and grow to best serve our clients.

We hope you enjoy this updated and expanded second edition of OLNS#7, a.k.a. the "Flip Ninja."

On behalf of the Orrick Team,

Sven Greulich
Orrick – Technology Companies Group Germany

A. US Holding Structures for German Start-ups / Set-up / Taxes / SAFE Financings and much more

I. Preface and Terminology Used in this Guide

We are frequently asked by (prospective) founders of and investors in German start-ups whether they should flip their German technology company into a US (as we will see, usually Delaware) holding company structure or in the case of an early-stage team, start with a US (holding) company right away.

In such a two-tier structure, the founders and investors indirectly hold their equity in the German start-up through a new US holding company. How founders can get into a two-tier structure largely depends on whether they have already incorporated their start-up in Germany or not. If not, the founders can set up the structure from scratch by (usually) first setting up their personal holding companies, then having such holding companies incorporate the US entity and in a final step, the US entity will establish a German subsidiary. If the founders have already established a German start-up and there is no easy option to "start over" with a new entity, the way into a two-tier structure usually requires a little reorganization, colloquially known as a "flip", as further described below.

As we will see, this structure comes with a variety of benefits, most notably an arguably better access to early-stage financing opportunities in the richer US funding ecosystem. Other advantages include improved exit opportunities as well as the opportunity to offer suitable talent a "Silicon Valley" style equity-based employee participation program.

However, moving a German start-up into such a two-tier US holding structure is a major corporate undertaking that comes with a variety of potential drawbacks and requires close cooperation of founders and existing investors as well as advice from legal, accounting and tax experts with experience on both sides of the pond. Keep in mind that once a GmbH is set up in a US holding structure, there's often no easy way of going back. While "backflips" from a US company into a German holding company (sometimes also referred to as "inversion" transactions) are legally possible, they often come with a huge tax bill and a host of practical issues.

Nevertheless, we think that it makes sense for German start-ups to consider a US/German two-tier structure early on in their lifecycle, as the mechanics of the flip process only grow more complex later in their life when more parties on the start-up's cap table with potentially diverging interests need to be coordinated. In addition, a flip in later stages of the start-up's financing lifecycle might become prohibitively expensive from a tax perspective.

Against this background we have put together this updated and expanded version of OLNS#7 (a.k.a. the "Flip Ninja") to not only help founders and investors assess the advantages and disadvantages of a US holding structure but also to give an overview of how to get into this structure and operate therein while navigating relevant legal, tax and other practical pitfalls.

It is said that "Experience is the teacher of all things." (Julius Caesar – there is no shame in reading classical literature, though it tends to make you lonely when you speak about it). However, this experience doesn't necessarily have to be undergone personally, but can be learned through others as well. Thus, we have asked some of the German founder teams whom we had the pleasure to advise when they set up a US/German two-tier structure for their enterprises to share some of their lessons learned. Throughout this Guide, we will share their insights.

To make our life easier, let's agree on a few definitions that we will use throughout this Guide:

- we will refer to the German start-up, *i.e.*, the business-carrying company (usually a UG (haftungsbeschränkt) or GmbH) as "**OpCo**";
- for the US holding company, often a Delaware corporation, we will refer to it as "**HoldCo**"; and
- for the founder's personal holding, usually a German entrepreneurial entity in the form of a UG (haftungsbeschränkt), we will refer to it as "**Founder HoldCo.**"

In Chapter A.II., we will take a closer look at the pros and cons of a US/German two-tier structure while Chapter A.III. will explain how to get into such a structure, be it by setting it up from scratch or flipping an existing German start-up company. The loyal reader of OLNS will have noticed that in all OLNS editions, a quote from Mark Twain can be found (we still stubbornly believe it makes us come across as smarter than we actually are), so here we go: In his collection of short stories and essays titled "Europe and Elsewhere" (published in 1923), our beloved author wrote: "I shall never use profanity except in discussing house rent and taxes." Well, while we will strive to keep a civil tone, Chapter A.III. will also take a closer look at some of the tax issues that can make getting into and operating in a two-tier structure complicated. Chapter A.IV. will give an overview of US corporate governance basics and focus on the role and liability risks of directors and officers in a US corporation.

Chapter A.V. is all about money. Amongst others, we will explain how SAFE financings are done and where they differ from German market convertible loan financings that many German founders will be familiar with. As we have mentioned already, a two-tier structure allows German start-ups to set up a "real", read equity-based, stock option program for its employees rather than relying on virtual plans or phantom equity programs that still dominate the German market. Therefore, the final Chapter A.VI. will give a brief introduction into US ESOPs and how they can be utilized.

> Please don't do anything stupid or kill yourself, it would make us both quite unhappy. Consult a doctor, lawyer and common sense specialist before doing anything in this book.
>
> *Tim Ferriss*, Tools of Titans

II. Pros and Cons of Having a Two-Tier Structure

In this Chapter we want to take a closer look at some of the advantages as well as potential drawbacks of a US/German two-tier structure.

> Try to understand the process yourself as much as possible, even if you have no legal background. Then make sure that every stakeholder is always on the same page, overcommunicate and the earlier you mention something the better.
>
> *Julian Lindinger*, Founder of PowerUs

1. ADVANTAGES OF HAVING A TWO-TIER STRUCTURE

There are various potential benefits for a German company that adopts a US holding structure. Not only do US companies have better access to US investors, but the new structure might also have a positive impact on its valuation and exit opportunities. It might also provide the start-up access to a richer talent pool, not only in the tech hotbeds in the United States but also in other international hubs.

1.1 Access to Investors

A central motive for the flip to the United States is that in many cases the start-up will receive improved access to the significantly more liquid US venture capital markets. The US has eight of the top 20 start-up locations worldwide, with Silicon Valley still reigning supreme. The only German location on this list is Berlin coming in thirteenth place.[2]

Despite the enormous progress that the European start-up and funding ecosystems have made over the last couple of years, the US investor base is still significantly larger with a more vibrant and developed venture capital scene and a stronger disposition to invest, especially in riskier ventures. Also due to deeper sectoral diversification, US investors may sometimes offer better know-how, contacts and guidance for first-time founders and early-stage companies.

> Currently, the signs are pointing to the US [as being a more attractive place to scale]. Often the US market is much larger for customers, there are more investors willing to lead at the Series B stage and the big acquirers are also in the US. The Nasdaq is also more attractive for listings so all of these things are factors for startups to consider moving. [...] [Europe] is catching up but it will take time.
>
> *Manjari Chandran-Ramesh*, Amadeus Capital Partners

2. The figures are taken from the 2023 Global Start-up Ecosystem Ranking published by the Global Start-up Genome Project.

US ACCELERATOR PROGRAMS

Unlike other well-known international accelerator programs, the world's arguably most renowned accelerator, the Y-Combinator (or simply "YC"), still – at least as a general rule – insists on a US flip for German start-ups as a condition to enter into its program and founders need to weigh this requirement against the expected benefits from the program. Currently, YC runs two three-month funding cycles a year, one from January through March and one from June through August. YC makes it a requirement for the founders of each start-up to move to the Bay Area for the duration of their cycle (though it had to temporarily adjust its program during the COVID-19 pandemic by relying largely on remote events and training sessions). Each cycle culminates in the famous "Demo Day," a three-day pitch event that can attract hundreds of investors, including some of the world's best seed investors. Throughout this Guide, some German YC alumni share the lessons they've learned from their flips.

Tech giants with massive exits, such as *Facebook*, *Google*, *Instagram* and countless others, have also created a rich secondary ecosystem of angel investors who know how to successfully scale a start-up on the technical and the operational side. While a discussion of macro-economic benefits of having a tax-efficient system for employee stock options in their start-ups goes beyond the scope of this Guide, in the US successful exits started powerful cascade effects. Here, employees cash-in their options in the case of a successful sale or IPO of their start-up, creating wealth that can be funneled back into new start-ups and spin-offs, which in turn create a new group of cash-rich entrepreneurs. According to some media reports, the *Google* IPO in 2004 made about 1,000 of its then 2,300 employees millionaires while catchy rumors around the *Facebook* IPO in 2012 said that the then record-breaking public debut would also produce "well over 1,000 millionaires" (according to reports by the *Daily Mail*) overnight. (*Facebook* had somewhat over 3,000 employees at that time.) Those and many other alumni, endowed not only with investable capital but with an appetite for risk and innovation, then went on to found companies of their own or became angel investors themselves, creating a virtuous cycle of funding, founding, innovation and financially rewarding exit that feeds itself.

This reservoir of (early-stage) funding and knowledge isn't as readily available in other parts of the world. For obvious reasons, US investors will often feel most comfortable with the corporate mechanics available in a US entity – *e.g.*, they understand and are comfortable with the way in which the rights of preferred stock can be structured under Delaware law while the nuts and bolts of our awesome German corporate law system remain alien to them (not to mention the notarization requirements for many corporate transactions and financings involving a GmbH...). In the US, continually updated and broadly accepted standard documents are available, be it for the very early stages through the so-called SAFEs (see Chapter A.V.1.) or for priced rounds by using the templates published by the *National Venture Capital Association* (NVCA)[4]. These are documents that many investors will simply assume as the template for their deals.

4. In our Guide OLNS#11 "Bridging the Pond", we give an introduction to the NVCA documentation and explain where NVCA deals differ from typical German market transactions, the Guide can be downloaded here: media.orrick.com/Media%20Library/public/files/insights/2023/olns11-bridging-the-pond.pdf.

> With our US Entity we got access to a rich Financing Ecosystem.

Flower

A conversation with Taner Topal, co-founder and COO of Flower Labs

Orrick: Hi Taner, in one sentence, what does Flower Labs do?

Taner: Flower is an open-source framework for training AI on distributed data using federated learning. Companies like Banking Circle, Nokia, Porsche, and Bosch use Flower to easily improve their AI models on sensitive data that is distributed across organizational silos or user devices.

Orrick: Maybe another sentence...

Taner (laughing): Almost all AI today is based on centralized public data – a small fraction of the data we have; we believe that training on orders of magnitude more data will unlock the next leaps in AI.

Orrick: Got it. And you did the flip?

Taner: Yes, we got accepted by Y-Combinator and moved into a Delaware holding structure.

Orrick: Looking back, what challenges did you come across?

Taner: You need a good advisor who helps you get things right from the start. Avoiding a permanent tax establishment of your US company in Germany...

Orrick: You mean, not running the Inc. out of Germany?

Taner: Correct. That requires careful planning, continuous monitoring, and a lot of documentation. You need guidance to navigate these challenges and be aware that it means work and a lot of travel time. Plus, you should invest in a good accountant and tax advisor early. It will cost you about half of what a mediocre one can cost you...

Orrick: What did you experience as the main pros of having a US/German set-up?

Taner: A US entity is an important building block in your equity story, it signals an international mind set and it gives you a better access to US investors.

Orrick: You made good experiences with your US investors?

Taner: Absolutely, our last round was led by Felicis Ventures and they have been great. Very focused and quick to move. They understand that the real work starts once the money has been wired. They put a lot of efforts into making intros for us, giving us feedback, and challenging our product and business ideas. Board meetings are really value-adding. In my experience, many US investors are used to making fast decisions and rapid execution. Plus, having standardized documents like the YC SAFEs and later the NVCA templates makes financing rounds relatively smooth. Although lawyers are still expensive...

Orrick: I pretend to not have heard the last remark.

Taner: Happy to repeat it... But seriously, another experience I made with the early-stage investors in the US is that many of them get that while they need their share of the pie, founder incentivization must take center stage

> Raising financing was one of our primary motivations for setting up a US/German holding structure. First, raising money through a SAFE is orders of magnitude easier than through other means. The SAFE allows for asynchronous signing, reduces the time required for negotiation, and it can be signed electronically. These factors were particularly important in times of COVID-19. Second, international investors felt much more comfortable with a standard corporate structure that they have seen many times before, which supports the valuation of the company.
>
> *Maik Taro Wehmeyer*,
> Founder of Taktile

Moreover, by operating through a US-domiciled company, the start-up may become eligible for investment from certain institutional investors that might otherwise be prohibited by their charters from investing in and buying securities of non-US companies.

However, founders should think carefully about their chances of raising money in the US and how much having a US holding company will actually improve their prospects. At the risk of sounding a bit too pessimistic (a common trait among our profession...), founders should think about the following aspects before they venture into a US holding structure:

- For later-stage companies (Series B and beyond), we noted that over the last couple of years, many US VC funds have become much more comfortable with investing in a German GmbH (that is, of course, if they invest in companies outside the US at all). In addition, we saw an increasing appetite of US investors for earlier financing rounds in German companies, and many of them already came in on the ground floor, *i.e.*, in Series Seed or Series A financings without requesting the start-ups to do a flip.
- For many early-stage companies, the best chances of getting funded are found more on a local level. Thus, US early-stage investors will often take a pass despite a US holding company being established unless a founder is prepared to move there and pursue a US business plan or show otherwise a clear US angle. In other words, a US holding company often is a necessary – but not sufficient – condition for US investors to lead a Seed or Series A financing.

  However, especially in the recent past, we have repeatedly seen US investors who were willing to invest in European early-stage companies, but still showed a clear preference for a US holding company, *e.g.*, because they find the need to notarize the investment and shareholder agreements in German start-ups too costly and cumbersome.
- On the flip side (no pun intended), German investors might feel more comfortable with a home turf legal entity such as a GmbH although we note that many of the most active business angels in Germany also gained quite some familiarity with US investments, *e.g.*, through SAFEs. There are also semi-public or publicly financed investors in Germany which may be prohibited from investing in non-EU entities.

The flip only Makes Sense if you get a EUR 1-2 Million Higher Valuation at the Seed Stage

Lidrotec

A conversation with Alexander Igelmann, CEO of Lidrotec

Orrick: Hi Alex, in one sentence, what does Lidrotec do?

Alex: We build machines with an innovative laser technology for the high-precision cutting of microchips, known as wafer dicing in technical jargon. We want to set new standards for a wide range of industries, from semiconductors to the energy sector, the medical industry and aerospace. Okay, that was two sentences…

Orrick: No problem. You started out as a GmbH and then did a flip, *i.e.*, you implemented a US holding between your operational GmbH and the shareholders. What was the motivation for this?

Alex: We operate in a global market in which there are only a limited number of relevant players. That's why we wanted to position ourselves more internationally right from the start. In addition, US investors we spoke to during this phase often showed a clear preference for a US set-up.

Orrick: When you look back on your flip, what are your key learnings?

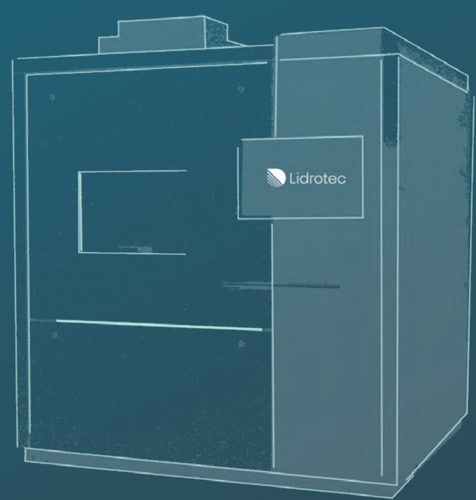
Alex: A flip is not a simple restructuring. It means real work, not only during the actual flip, but especially afterwards. Nobody should do it just because it's fashionable - to be clear, a US structure is not a cool gimmick. You have to be aware that maintaining a US holding alone costs a five-figure sum per year and that the coordination effort between the two worlds also has an impact on the founders. To make it all worthwhile, you need a long-term story and have to think about several rounds of financing.

Orrick: Talking about fundraising…

Alex: Yes, one of the central motives for us to do the flip.

Orrick: And?

Alex: With an American company and a credible international story, you naturally become more interesting for the much larger universe of American investors. Some of them are also put off by our German structures - just think of the need to go to a notary for every share issuance or financing round. Of course, some doors in Germany may be closed in return, *e.g.*, with regard to certain public funding pots. However, I believe that a flip pays off in the long term if in the seed stage you can achieve a valuation that is at least one to two million euros higher for the same investment amount and comparably good investors. The dilution that you can then avoid is worth a lot in the long term if your start-up develops well. In our experience, US investors often offer better valuations in this crucial early phase.



1.2 Valuation and Exit Options

We don't want to comment on the merits of these claims, but the reality is that many (primarily US-based) VC investors believe that a US entity will offer more advantageous opportunities for an "exit," either through an acquisition or an initial public offering (IPO). The main reasons for this argument are:

- start-ups with a US – this often means a Silicon Valley – story can often fetch higher valuations;
- chances are that many of the potential acquirers will be US-based private equity investors or corporations; and
- the US has some of the world's premier stock markets that, compared to other internationally recognized stock exchanges, seem particularly suited for IPOs of young technology companies.

Higher Valuations: Start-ups with a "Silicon Valley story" tend to receive higher valuations in future financing rounds and in exit scenarios. There is real appetite of US VC investors for European tech companies (and setting them up with a US holding structure can facilitate financing rounds led by such US investors).

The "Deutscher Startup Monitor 2023", published by the German start-up association (*Startup Verband*) together with the consulting firm *PwC*, summarizes the current situation and the ongoing problems of German start-ups on the financing side as follows:

The high prevalence of early-stage financing - whether public funding or business angels - is good news for the ecosystem. This is because this capital creates the basis for the development of companies, especially when time is needed to achieve market readiness. But where does Germany stand in an international comparison? Conclusion: At a similar level to France, but well behind countries such as the USA or the Netherlands. However, the gap has at least narrowed somewhat - as recently as 2018, there were almost four times as many seed financings per capita in the US as in Germany, but recently only around two to three times as many. [...] The gap is significantly larger in the area of growth financing. From the beginning of 2020 to the end of June 2023, EUR 1,157 per capita were invested in the US in financing rounds of at least EUR 100 million – almost six times the German figure. In addition, there is a high dependence on American investors: In Germany, for example, almost half of these financing rounds (46.1%) come from US investors – in contrast, in the US around three quarters of such investments (74.9%) are made by domestic players."

Convenience translation of the original German text prepared by the authors

The 2023 State of European Tech Report published by VC investor *Atomico* came to a similar conclusion regarding the importance of US money for German start-ups and summed its findings up as follows:

> What is notable, however, is that the relative weight of US investment to European investment differs quite significantly between these countries. At the peak in 2021, every dollar invested into either a UK or German tech company by a European investor was matched by US investors to the tune of 86 cents in the UK and as much as 93 cents in Germany. By comparison, the equivalent number for French tech companies was around half at 43 cents.

Acquisitions by US Acquirers: When considering a sale of the start-up to a (US) acquirer as an exit route, it must be noted that, on average, valuations for technology companies are higher in the US and many US corporations have ample experience in acquiring emerging companies as part of their innovation and growth strategy, while start-up M&A is still an emerging field in the German market (though – at least prior to the COVID-19 pandemic – it was definitely on the rise). Operating through a US company may ease such an exit process given that US-based acquirers will likely be more comfortable dealing with the corporate mechanics and structuring of the acquisition of a US target. Furthermore, certain favorable acquisition methods such as the US-style "forward or reverse triangular statutory merger" are not available for non-US companies.

US IPO: Given persistent macroeconomic and geopolitical headwinds, the recent lack-luster performance even of high-profile tech IPOs that until recently traded at low multiples, companies are likely not particularly eager to go public until at least late 2024. While some market observers expect the IPO window to reopen at least somewhat in the course of 2024 especially when the Fed may start cutting interest rates, the ongoing presidential election cycle may delay such a reopening until 2025. Nevertheless, in the US, an IPO is still frequently seen as a significant step in the maturation of a business from a small start-up stage to a successful operating company. Technology investment bankers and VC investors often argue that a listing of a US company on NASDAQ or NYSE will come with the benefits of a higher valuation and increased liquidity (which in turn enable VCs to exit the company without adverse trading consequences).

A discussion about the advantages and disadvantages of an IPO for the success of a start-up is beyond the scope of this Guide. In addition, over the last years we saw a clear trend towards young tech companies staying private for much longer periods of time than in the past. Today, most start-ups will be in business for a number of years and complete several financing rounds before they can prepare to go public. However, while we believe that it makes sense to think about exit scenarios early on and build a surplus of flexibility into one's corporate structure (remember, a flip later down the road will often be way more expensive from a tax perspective).

We also want to point out that becoming a US company is not a requirement for a US IPO, as non-US companies can list on US stock exchanges as well (albeit that the process can be more expensive and cumbersome than a listing for a US company and valuations might in some cases take a hit as well). To this end, German start-ups often choose the route of reorganizing the start-up under a Dutch public limited company (*Naamloze Vennootschap - NV*). The NV is an internationally recognized legal form which, due to the flexibility of Dutch law with regard to share registers and share certificates, enables the common shares of the NV to be listed on US stock exchanges without having to rely on a so-called American Depository Shares program. Examples of this in recent years include, among other German companies, the IPOs of *Affimed Therapeutics*, *Trivago*, *Curevac* or *Sono Motors*. An alternative is to restructure the German start-up as a Societas Europaea (SE), as the US-IPOs of *BioNTech* and *Ecotec* show. Compared to a NV reorganization, however, the (arguably minor) disadvantage here is that the common shares cannot be listed directly, but only via an American Depository Shares program. Further, the rather flexible provisions of Dutch law provide the corporate governance of the NV with a similar "look and feel" to that of US companies and may therefore be more familiar to US investors than the rather formalistic SE regime.

1.3 Access to Talent Pool and US Employee Incentive Programs

Finally, tapping into the rich talent pool of Silicon Valley and other US tech hubs is easier for a US legal entity as it can offer standard, market-tested equity-based employee participation programs with stock options. One potential disadvantage that German tech companies face when competing for talent in the US clusters is that often they cannot offer their prospective hires equity compensation. While under certain circumstances shares in a Delaware C corporation can provide US taxpayers with tax advantages, such tax advantages are not available for US taxpayers under typical German market employee participation programs (particularly if they are phantom equity or "virtual" programs, which is still the standard approach in Germany). Following a flip, a US style employee stock option program (ESOP) can be established at HoldCo (for details see Chapter A.VI.).

An Inc. and a real ESOP are Assets when it Comes to Hiring

THRONE

A conversation with Heiner Stinner and Pascal Lange from Throne

Orrick: Dear Heiner, in one sentence, what does Throne do?

Heiner: Throne attacks the big issue of creator commerce. We are building an infrastructure with which artists all over the world can create a wish list and then be supported by their fans without them finding out the creator's private address.

Orrick: You haven't chosen the typical set-up of many German-American start-ups...

Pascal: Exactly, we started with an Inc. and later incorporated a GmbH as a subsidiary. However, our Inc. was operational right from the start and not just a holding company.

Heiner: Of course, this presented us with particular challenges, as we didn't want to run the Inc. from Germany for the well-known tax reasons. We therefore hired a CEO in America early on and are often in the US to hold board meetings and prepare and implement important decisions. In fact, I made the trip over the pond at least once a month. Over time, we have built up more and more substance there.

Orrick: That's certainly not always easy?

Pascal: Yes, and that must be clear to every founder who is thinking about such a structure.

Orrick: But why an Inc. at all? What was your motivation?

Heiner: There were several reasons. The whole topic of the creator economy is just so much bigger in America. Many potential US customers signaled a preference for an American company. In addition, an Inc. and the possibility of a real equity-based employee participation, as is common in American start-ups, helped us to attract important talent.

Pascal: And not only abroad, but also in Germany.

Heiner (laughs): One of our developers once said that having a Dot.Com domain is the Patek Philippe of software developers... maybe the same is true for having an Inc. and an international ESOP if you're looking to attract international talent...

Orrick: You launched in 2021. What were your biggest learnings?

Pascal: Invest in good lawyers from the start...

Orrick: We like that.

Pascal: But it's true. There are so many myths and half-truths in circulation and many founders just get started. You know, move fast and break things... That may be absolutely right in other situations, but if you set up an international structure incorrectly, it's expensive and annoying to correct it later.

Heiner: Find a good tax advisor in Germany early on who is familiar with both sides of the Atlantic. But most importantly: have a clear US angle, a long-term story that makes this set-up exciting for investors and employees.

2. DISADVANTAGES OF HAVING A TWO-TIER STRUCTURE

On the – be careful, lawyer humor ahead – flipside, founders and existing investors of a German start-up also have to assess the disadvantages and potential drawbacks of a two-tier structure in general and a flip in particular.

2.1 Additional Complexity

Let's get philosophical for a moment. "Complexity is the enemy of execution." Sounds sophisticated, right? Yes, we know, that quote is not ours but stems from *Anthony "Tony" Robbins*, bestselling author and successful coach, and it is also taken out of context here; however, it is catchy and summarizes one of the most relevant drawbacks of a two-tier structure. The unknown US legal system and the two corporate and tax layers will simply add complexity to your business structure. Complexity can be a huge drag threatening the only two real advantages many start-ups have: Speed and focus.

Tax Considerations: Most notably, when establishing a two-tier structure, the founders need to be aware of various tax pitfalls.

- If there is already an OpCo, the flip itself will result in a taxation on the spread between the fair value of the shares in OpCo and the so-called initial acquisition costs of the respective shareholder for such shares.
- To foreshadow another aspect that we will revisit later on and that is relevant for all US/German holding structures (be they established from scratch or through a flip), it should be reviewed whether it can (to the extent possible) be avoided that HoldCo becomes a "dual-resident" from tax perspective.
- The start-up will also face greater tax complexity in another regard as well since OpCo, as a subsidiary of HoldCo, may be a so-called "controlled foreign corporation" (CFC) and may need to be included in the US tax return of HoldCo, although income of OpCo will still be taxed in Germany. In addition, rather extensive reporting and accounting obligations apply with respect to OpCo now being a CFC.

Rest assured, we have more tax considerations to discuss in the context of setting up a two-tier structure, and we can imagine how much you are looking forward to reading about those as well (see Chapter A.III.3.).

Operating in an Unknown Legal Framework: Whereas German founders will be more or less familiar with their home country's legal framework (at least one would hope they are), expanding to the US adds further complexity to their business. The founders are confronted with a significantly different legal governance system. As we will see below, the "board concepts" of a German GmbH and a US corporation are different and the roles of directors and officers in a US corporation come with a number of duties and liability risks that are not always comparable to what we have here in Germany.

Furthermore, though we are not aware of any empirical evidence supporting this claim, some founders fear that by setting up HoldCo, their start-up might be subject to litigation in the US at an earlier point in time.

WHEN A FLIP IS <u>NOT</u> REQUIRED

Only because we have encountered this question over and over again: A flip is not called for if the goal is to simply do business in the US, *e.g.*, sign contracts and hire people there. In most of these cases, setting up a US subsidiary of OpCo will suffice. As a further side note, even if a flip is implemented, it is often beneficial to keep HoldCo as a mere holding company and concentrate all commercial and operational activities in the US in a separate US subsidiary of HoldCo, *i.e.*, a sister company of OpCo. The reason is that it should generally be avoided to have HoldCo be run from German soil (see Chapter A.III.3.2.) and having an operational HoldCo with lots of business transactions makes this much harder than a HoldCo whose role is limited to fundraising and issuing options under a US employee stock option program.

2.2 Transaction Costs

A further concern are the out-of-pocket costs of setting up a two-tier structure. These costs can run into the tens of thousands, especially in the case of a more complex flip. For example, as we will see, after various fundraising rounds, a company has to balance numerous competing shareholder interests when planning a flip. However, in simpler cases, especially when the structure is set up from scratch, we have managed to bring down the legal costs substantially, notably through a proprietary digital tool that walks founders through the various steps and provides practical guidance.

One thing German start-ups should also be aware of is that their legal costs after a move to the US will be higher (though we would usually counsel our clients to think of legal costs more as an investment into avoiding higher costs down the road, but we may be biased here…). *John Harrison*, partner in our San Francisco office observes: "In my experience, many German companies underestimate the costs to compete in the US market. Running your business is more expensive, as are the funding rounds and the exits. If you decide to flip, you have to be willing to invest the necessary money."

Estimates vary, but many studies find that US companies in general spend at least two times more on legal costs compared to their global peers. While we are not aware of similar studies that focus on researching legal costs for start-ups, we believe that patterns are likely similar here as well. While the US entity can be set up fairly inexpensively, legal costs thereafter quickly ramp up.

III. Getting into a Two-Tier Structure

How founders can get into a two-tier structure largely depends on whether they have already incorporated an entity in Germany or not, *i.e.*, whether or not there is already an OpCo.

- If they haven't yet incorporated (or their existing OpCo is still very "nascent" and can be "left behind" by transferring existing assets (often a bit of IP and maybe some first contracts) to a new OpCo without triggering significant tax liabilities, *i.e.*, usually only when the existing assets and agreements are still of little value), the founders can set up the structure from scratch by (in most cases) first setting up their Founder HoldCos, then having their Founder HoldCos incorporate HoldCo and in a final step having HoldCo establish OpCo.
- If the founders have already established OpCo and there is no easy option to "start over" with a new OpCo, the way into a two-tier structure usually requires a little reorganization, colloquially known as a "flip," as further described below.

1. SET-UP FROM SCRATCH

If the founders have the opportunity to start with a blank slate, they would in the simplest form first set up (US) HoldCo and that HoldCo in turn would incorporate (German) OpCo. However, given that in this scenario the founders are not constrained by legacy decisions, it makes sense to pause for a moment and consider a usually more tax-advantageous solution with first setting up Founder HoldCos for each founder and then have these Founder HoldCos rather than the founders themselves set up HoldCo.

1.1 Personal Holding Companies – Generally Advisable But There May Be Exceptions

Founders (similar considerations apply to business angels or other people investing in the company) can hold their shares in HoldCo either directly or through Founder HoldCo. While holding one's participation through a Founder HoldCo makes the financing documentation a little more complex and causes some costs for setting up and maintaining the Founder HoldCos, it is worth thinking about an adequate holding structure early on, as its implementation at a later point in time can have negative tax consequences.

> We learn geology the morning after the earthquake.
>
> *Ralph Waldo Emerson*

The main reasons and benefits for holding one's shares in HoldCo through Founder HoldCos are tax-driven. We have explained the underlying tax rationale in (some might say "painful") detail in another Guide[6] and refer you to that publication.

While usually at least for founders who are resident in Germany upon incorporation of HoldCo and who anticipate to be still resident in Germany upon the time of a liquidity event (*e.g.*, a sale of the company or an IPO), setting up Founder HoldCo is usually advisable, the situation for founders outside of Germany or who anticipate to relocate to another country prior to such liquidity event can be more complex and often requires an in-depth assessment that we cannot do within the limits of this humble publication.

6. See OLNS#9 "Venture Capital Deals in Germany" – the Guide can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/2021/OLNS9-VC-Deals-in-Germany.pdf.

That being said, when looking at the case of a founder who anticipates to move to the US and considers it relatively likely to be in the US upon the time of the liquidity event, the following considerations may serve as general guidelines:

- If the founder is certain to be resident in the US at the time of the liquidity event, it should regularly be advisable to decide against a Founder HoldCo.
- If the founder is unsure whether he or she will be in Germany or the US at the time of the liquidity event, based on a risk-/benefit assessment, a Founder HoldCo is often advisable.
- If the founder chooses a Founder HoldCo, he or she should consider applying for a so-called "check open election" for their Founder HoldCo with the relevant US tax authorities. Thereby, if the founder is resident in the US at the time of the liquidity event, potential US tax disadvantages can usually be reduced. The exercise of the "check open election" should already be made at the time of formation or in any event when moving to the US or otherwise becoming a US taxpayer becomes a realistic scenario.

However, it needs to be kept in mind that moving to the US and then back to Germany will, irrespective of whether or not a Founder HoldCo is used, trigger questions around exit taxation (see below in Chapter A.III.3.2.2.).

1.2 Setting up HoldCo

1.2.1 What Company Form to Choose?

In most cases, it is advisable to incorporate HoldCo in Delaware. US companies are most commonly incorporated in Delaware because of the state's business-friendly reputation, which includes flexible business formation statutes (allowing flexibility in structuring business entities and allocating rights and duties), specialized, highly experienced courts dedicated to hearing corporation cases (which brings with it the additional benefit of well-established case precedent, which, in turn, provides greater guidance reducing the risk of litigation) and an efficient Secretary of State (which reduces administrative burdens and holdups). Most US investors also tend to prefer Delaware because of the ease with which capital stock can be transferred (including the ability to go public). Furthermore, the corporate law of Delaware enjoys the advantage of being widely familiar to legal practitioners across the US.

Under Delaware law, it is possible to choose between the following company forms:

- **C Corporations:** Most venture capital-backed companies are C corporations and unless there are compelling other reasons this should be the preferred choice for German founders (we will present a few other available company forms mainly for the sake of completeness and as good lawyers we have a built-in aversion against simplicity...).
- **S Corporations:** These, like C corporations, are formed under state law. An S corporation is a closely held corporation (not more than 100 stockholders) that makes a valid election to be taxed under Subchapter S of Chapter 1 of the US Internal Revenue Code. This election results in the corporation becoming a pass-through entity for tax purposes (meaning that the S corporation itself does not pay income tax; rather, profits and losses are passed through and divided among the corporation's stockholders).
- **LLCs:** This (relatively) new legal form of a limited liability company, which is also subject to the laws of the individual states, can be treated for tax purposes in the US and Germany as a partnership, corporation or sole proprietorship. In the US, there is an option to do so, whereas in Germany it has to be examined within the scope of a comparison of legal types whether the specific LLC is to be treated as a partnership or as a corporation. In case of doubt, however, the tax situation becomes more complex when using an LLC (*e.g.*, if a conflict of qualification arises). Founders who sooner or later want to bring VC investors on board should not set up their company as an LLC, as VC investors are often not allowed to invest, or interested in investing, in such corporate forms.

1.2.2 How to Incorporate

The basic constitutional documents relevant for HoldCo are the certificate of incorporation (also known as the charter), which establishes the formation of the corporation upon filing with the Secretary of State of the state in which the corporation is incorporated (*i.e.*, usually Delaware), and the bylaws, which set forth the fundamental rules and procedures by which the corporation will be governed (*e.g.*, how board and stockholder meetings are called, roles and duties of officers of the company, etc.). As promptly as practicable after incorporation, the incorporator typically elects the initial board of directors, which then holds its first organizational meeting in which shares of stock are approved to be sold to the incoming shareholders, officers are appointed, and other initial actions are authorized.

CHOOSING HOLDCO'S NAME

When picking a company name, it is important to do research to help avoid trademark infringement or domain name problems and to ensure that the chosen name is actually available to use. Someone's trademark may be infringed if the use of a mark is likely to cause confusion among customers as to the source of the goods or services. Here are some steps to take in order to avoid naming issues. Founders can do the first steps themselves and then provide their US counsel options for further review and confirmation (the last two bullets should, however, be done by a US counsel):

- Do a Google search on the name to see what other companies may already be using the same or a similar name.
- Do a search on the US Patent and Trademark Office site for federal trademark registrations on your proposed name.
- Do a search on GoDaddy.com or other name registrars to see if the domain name you want is available. If the ".com" domain name is taken, this could signal the potential of prior use and is therefore a red flag.
- Do a search of Secretary of State corporate or LLC records in the states where the company will do business to see if anyone is using the same or a similar name (with results of search to be confirmed and verified by US counsel)[8].

8. For Delaware, see: https://icis.corp.delaware.gov/ecorp/entitysearch/namesearch.aspx

These are the most common documents that German founders will encounter when setting up HoldCo:

Corporate Docs	
Action of Incorporator	One of the founders (or a representative such as US counsel) will in its capacity as incorporator: • appoint the designated board members; and • adopt the bylaws by virtue of an action of incorporator.
Charter	HoldCo will come into existence once the charter has been filed. Among other things, it states the authorized capital stock of the company.
Bylaws	The incorporator and the secretary of HoldCo (the secretary is one of the company's officers) will certify the bylaws of HoldCo.
Stockholder Consent	Founders/Founder HoldCos as future stockholders of HoldCo will approve the indemnification agreements and the stock plan.
Initial Board Consent	The board will appoint the officers by means of a written resolution and to grant its consent to the execution of indemnification agreements and other organizational matters.
Common Stock Purchase Agreements	HoldCo will issue shares of (usually) common stock to each founder/Founder HoldCo by entering into common stock purchase agreements.
Indemnification Agreements	See below under Chapter A.IV.2.2.

Stock Plan (ESOP)	
Stock Plan and Accompanying Documents	See below under Chapter A.VI.

Other	
Application for EIN	HoldCo will need to apply for an "Employer Identification Number" (EIN) from the Internal Revenue Service of the US. The EIN is, inter alia, required for opening a bank account. The EIN can be applied for online if the application is made by HoldCo representative holding a US social security number, EIN, or individual tax identification number (ITIN). If applied for online the EIN is issued immediately. Otherwise, the application must be made by mail or fax. Note that the issue of an EIN can in this case take several weeks. For details see Chapter A.III.1.2.4.
Section 83(b) Elections	For details see Chapter A.III.1.2.4.

HOLDCO'S ADDRESS AND HOLDCO'S REGISTERED AGENT

The charter must, amongst other things, state the address of the company's registered business office in Delaware and the name of its registered agent. Here, in our experience founders get sometimes confused. So, to be clear: Your registered agent is not your HoldCo's business address.

Rather, HoldCo requires a US address for its tax registration and the procurement of an Employer Identification Number (EIN). Many of our Germany based clients have in the past worked with service providers such as Stable (https://www.usestable.com/) for the set-up of their US address. But be careful, for the question of whether HoldCo is tax resident in the US or Germany (there is hardly a more exciting question for our tax colleagues, and we will have to come back to this in detail, see Chapter A.III.3.2.), a US address is only one of several indicators to be considered.

1.2.3 New Transparency Requirements for HoldCo – The CTA and FinCEN

Starting from 2024 on, US corporations (such as HoldCo) need to comply with the US Corporate Transparency Act ("**CTA**"). With references to the Small Entity Compliance Guide by the US Department of the Treasury (currently version 1.1 as of December 2023 – "**FinCEN Guide**"), founders need to manage the new Financial Crimes Enforcement Network ("**FinCEN**") reporting requirements. The CTA imposes compliance obligations on HoldCos, necessitating a thorough understanding and transparent reporting of their beneficial ownership structures to FinCEN.

The CTA defines reporting companies as

- "domestic" or "foreign" entities,
- that do not qualify for an exemption.

Domestic and Foreign Entities: A domestic reporting company is defined as any entity that is a corporation, a limited liability company, or is created by the filing of a document with a Secretary of State in a US state. A foreign reporting company is defined as any entity that is a corporation, a limited liability company, or other entity formed under the law of a foreign country and registered to do business in any US state by the filing of a document with a Secretary of State in a US state. HoldCos will usually qualify as domestic reporting companies.

Exemptions: The CTA lists in total 23 specific exemptions, including publicly traded companies, non-profits, and large operating companies. While HoldCos in typical two-tier holding structures should usually not fall under any of these exemptions, an in-depth assessment might be necessary in individual cases.

Please note that a parent company cannot file a single report on behalf of its group of companies. Each company that meets the above stated requirements is obligated to file an individual report. Thus, if HoldCo should not only have German OpCo but also (operational) US subsidiaries, the latter need to make their own filings.

Reporting companies that do not qualify for an exemption need to file their beneficial owners with FinCEN. Beneficial owners are individuals with either:

- substantial control over the reporting company; or
- that, directly or indirectly, have at least 25% ownership interest in the reporting company.

Substantial Control: An individual is considered to have substantial control over a reporting company if they meet one of four criteria:

- being a senior officer;
- having the authority to appoint or remove key officers or directors;
- acting as a primary decision-maker; or
- possessing any other significant form of control over the US entity. Such control may be direct (*e.g.*, board representation (on case-by-case basis)) or indirect (*e.g.*, through business or financial relationships).

Reporting companies must identify all and at least one such individual(s), with no limit to the number of individuals who can meet these criteria.

>25% Ownership Interest: An individual is considered to have a beneficial ownership interest in a reporting company if he or she owns or controls at least 25% of its total ownership interests (such total ownership interests are to include equity, stock, voting rights, capital or profit shares, convertible instruments (see below), options, or other means that establish ownership).

As a general matter, a beneficial owner in this context can only be an individual and not a legal entity. Therefore, the beneficial owner can never be the Founder HoldCos but only the founders behind the Founder HoldCos.

So far, FinCEN has not issued guidance on how outstanding convertible instruments are to be taken into account for calculating the total ownership interest other than indicating in the rule that if an overall percentage ownership cannot be determined, an analysis of percentage ownership of a particular class of ownership can suffice, which would result in a reporting person owning 25% or more of the respective class. For SAFEs and other instruments, there is so far no guidance, but several law firms consider using paid-in capital as a proxy.

Reporting Deadlines: US entities formed after 1 January 2024 need to make their filing within 90 days following the effective date of their formation while existing entities have until end of 2024. Relevant changes regarding the information in a previously filed BOI (beneficial ownership information) report must be reported within 30 days of the change or when the reporting company becomes aware or has reason to know of the inaccuracy of information in earlier reports.

1.2.4 Some other Practical Issues to be Considered when Issuing Shares in HoldCo

While issuing shares in HoldCo is generally pretty straight forward (for the legally minded, unlike in Germany shares are not issued through a share capital increase and a subscription declaration like in a GmbH but are purchased from the company through a stock purchase agreement), there are a few pitfalls and considerations that founders should be aware of. While the list below is not meant to be comprehensive, it should give founders a good overview of some of the most relevant aspects.

US Securities Filings: When companies issue securities in the US, they need to ensure that the issuance is in compliance with US federal and state laws and regulations aimed at protecting investors. The Securities Act of 1933 requires the offer or sale of securities to be registered with the Securities and Exchange Commission ("**SEC**") unless they qualify for an exemption from registration. Many companies conducting equity financings will rely on safe harbor exemptions under Regulation D of the Securities Act of 1933, which requires the company to file a notice of exemption with the SEC. Each US state also has separate and distinct laws and regulations that may require companies to notify states of the issuance of securities to investors in those states. So as always (not that we are biased here...) you should work with US counsel to ensure these filings are properly completed and filed within the relevant timeframes.

Uncertificated Stock and Electronic Stock Certificates: If approved by the board of directors, Delaware corporations are allowed to issue what is known as "uncertificated stock" or electronic stock certificates, rather than paper stock certificates. "Uncertificated stock" means that a stock certificate does not need to be issued to a stockholder to represent ownership of shares in the corporation. Instead, Delaware corporations may send a stockholder a notice of issuance of shares. Electronic stock certificates provide the same information as a paper stock certificate but in electronic form. Many capitalization table management platforms for US companies facilitate the distribution of electronic stock certificates, which will ease the administrative burden of having to issue paper stock certificates.

Section 83(b) Elections: Founders will want to consider filing a US tax election with the IRS, known as a "Section 83(b) election", within 30 days following the date on which they are each, via their Founder HoldCos, issued stock in HoldCo that is subject to vesting. Bear with us, the below sounds again very formalistic but there might be rather substantive amounts at stake…

Under US federal income tax law, the issuance of non-transferrable restricted stock (for example, from a restricted stock grant or early exercise of a stock option) is generally not a taxable event. Instead, the individual is taxed at ordinary income rates (a maximum federal rate of 37%, plus applicable state and employment taxes) on the difference between the fair market value of the stock at the vesting date and the amount they paid for the stock (*i.e.*, the "spread," which in some cases may be zero) as the stock vests. However, if a Section 83(b) election is timely made at the time of the issuance of the restricted stock, the individual is taxed at ordinary income rates on the spread at the time the stock is granted, at the value of the stock at the time of grant, rather than at the vesting dates. Subsequent appreciation of the stock is generally eligible for favorable capital gain treatment. If an individual not subject to US taxation at grant (called for simplicity's sake in this Chapter a "nonresident") timely files a Section 83(b) election, the nonresident should not be subject to US taxation at ordinary income rates on the restricted stock as it vests. However, if the nonresident does not timely file a Section 83(b) election and becomes subject to tax in the US during the vesting period, the nonresident will be subject to US taxation at ordinary income rates on the restricted stock as it vests.

Accordingly, if a nonresident may possibly become a US citizen or resident or otherwise relocate or perform services within the US during any period in which the stock is held by the nonresident, the nonresident should strongly consider filing a Section 83(b) election for their shares.

A Section 83(b) election must be filed within 30 days of the purchase of the restricted stock at the US Internal Revenue Service Center where the taxpayer would normally file a US federal income tax return. Although the Section 83(b) election itself is a short and simple document, the election gives rise to unique issues for nonresidents. This is because the applicable regulations require that the nonresident provides a US taxpayer identification number ("**ITIN**") on the election.

In our experience, nonresidents typically do not have an ITIN and are often reluctant to get one due to the complexities in the application process and fear of being swept into the US taxing net. Obtaining an ITIN, by itself, should not subject a nonresident to US taxation. However, in our experience the IRS has been administratively inconsistent in its responses to ITIN applications and Section 83(b) elections by nonresidents and the tax filing process may generate contact from the IRS to confirm that no US federal income tax returns are required to be filed by the nonresident.

The safest approach is for the nonresident to obtain an ITIN before filing the Section 83(b) election, and this is particularly recommended if the nonresident is likely to relocate or otherwise become subject to tax in the US at any time during the period of vesting.

As the above summarized process is rather formalistic and nuances need to be observed, *e.g.*, when the ITIN isn't granted in time or a nonresident should decide to make an election without an ITIN, nonresidents should consult qualified counsel to understand the US tax consequences of the receipt of restricted stock in their particular circumstances.

1.3 Setting up OpCo

OpCo can be set up just like any other German company. The only particularity is that the only shareholder of OpCo will be HoldCo so that the officers of HoldCo need to represent HoldCo during the incorporation process (usually, one officer will suffice).

IS (GERMAN) OPCO REQUIRED?

Some founding teams ask themselves whether having an OpCo is really necessary. This is especially true for founding teams that have no problem ensuring that HoldCo is not run from Germany, *e.g.*, because the founders are (entirely or predominantly) based in the US. Isn't it enough to set up HoldCo as a fully operating company? A foreign company such as HoldCo can simply have a branch office entered in the German commercial register instead of setting up its own subsidiary. At least in the initial phase, when money is tight and there are perhaps no or only a few local employees in Germany.

This is a complex question that requires a precise analysis of the individual case and depends in particular on the plans for the development of the start-up in Germany. The founding team will have to ask itself the following questions, among others:

Can we really run HoldCo from the US? If HoldCo remains a pure holding company and its activities are, thus, limited, it still has a fighting chance to avoid dual tax residency in Germany and the US, even if it is managed by individuals living in Germany (if they effectively manage HoldCo from US soil). However, if HoldCo becomes operational and management activities are required on a daily basis, a founder team based in Germany will have a tough time convincing German tax authorities that HoldCo's central place of management is not in Germany. Additionally, if the Inc. is already considered tax resident in Germany and later relocates its place of management from Germany, this will also lead to an exit tax on HoldCo's level.

What is our hiring strategy for Germany? In principle, there is no need for OpCo just to hire individual employees in Germany. Employees can generally also be employed via special service providers. These so-called Employers of Record hire employees based in Germany and provide them to the start-up as part of a so-called employee leasing arrangement, without the start-up needing a German subsidiary to act as employer.

However, this approach has its limits, depending on the type of personnel and the purpose for which the start-up is looking for talent in Germany. It is not so much the costs that the service provider charges (these are the salary-related costs of the employee and a service fee). Rather, knowledge workers in particular may have reputational issues with their status as temporary workers (*Zeitarbeiter*) and it should be kept in mind that the maximum duration of a temporary employment contract in Germany is 18 months. If the employee in question is to continue working for the start-up after this period, he or she must be permanently employed by the start-up anyway.

Does the business model suggest a local subsidiary? Where are the customers located and what do they expect? Do the (hoped-for) customers of the start-up feel comfortable contracting with a US company or will they prefer a German contractual partner due to market opportunities etc.?

If a subsidiary is established when entering the German market, this is often seen as a stronger indicator of a robust and lasting presence in Germany. Concluding a contract with a foreign company, on the other hand, could be seen as riskier as this company can quickly withdraw from the German market.

Although Germany is not a particularly litigious country, a separate legal entity provides additional protection as the liability of HoldCo is generally limited to OpCo's share capital, whereas without a separate legal entity, HoldCo would be directly liable.

Where should the IP be located? If there is OpCo and it has employees who create IP, the question arises as to where this IP should be "located." This can be at OpCo or, if the GmbH concludes a corresponding agreement with the American parent company, at the parent company (in larger corporate groups, the IP is sometimes bundled in a group company, primarily for tax reasons). This is a complex question which must be examined on a case-by-case basis.

It is advisable to choose either a GmbH or a UG (haftungsbeschränkt) as OpCo. The main difference between both company forms is that while a GmbH's minimum share capital amounts to EUR 25,000, in the UG (haftungsbeschränkt), EUR 1 is theoretically sufficient (though for practical purposes we usually see a somewhat higher share capital amount for UGs).

After having taken the decision to form OpCo, the incorporation deed with the company's first set of articles of association needs to be notarized. Afterwards, the managing directors (*Geschäftsführer*) for OpCo are appointed who can but do not need to be the same as HoldCo's directors or officers.

We have also experienced in the past that founders have already set sail for the US and may therefore not be available in Germany to have the incorporation documents for OpCo notarized in front of a German notary. In such case the notarization can be executed by a representative (*e.g.*, a lawyer) on behalf of HoldCo based on a power of attorney. German law requires that a power of attorney granted for the incorporation of a GmbH or UG (haftungsbeschränkt) must itself be notarized by a notary who can also be commissioned in the US (in such a case, an apostille is required). However, while the incorporation of OpCo can be done based on a duly executed power-of-attorney, such a representation is not possible when it comes to the confirmations and assurances that the designated managing directors of OpCo need to make towards OpCo's commercial register, *i.e.*, the managing directors need to appear in front of a notary. This can also be a foreign notary but that will require a bit more complex formalities.

Next, HoldCo as the only shareholder of OpCo needs to pay the minimum contribution which amounts to half of the share capital (assuming the standard case of a company founded by cash rather than in kind). If, *e.g.*, OpCo has a share capital of EUR 25,000 (the minimum capital required for a GmbH), only EUR 12,500 need to be paid as a contribution at this stage (certain exceptions apply).

Finally, OpCo's managing directors need to file an application for the company's registration with the competent commercial register. As soon as the company is entered into the commercial register, OpCo is set up.

2. FLIP

Now, finally, let's get to the famous "flip." As mentioned above, a "flip" refers to the "transfer" of an existing entity into a US holding structure. In this process, the shareholders "swap" or "flip" their shares in the business-carrying (German) OpCo for shares in (US) HoldCo.

Usually, assets, intellectual property rights and employees remain with OpCo while HoldCo assumes the role of a holding and management company that sometimes also enters into business relationships with customers in the US (though for various reasons, it is often more advisable to establish another new US company beneath HoldCo, *i.e.*, a sister company to OpCo, to act as operating company in the US market). Especially when the founders will not move to the US, it is often advisable to strictly limit HoldCo's role to fundraising and issuing stock options under an employee stock option program to be set up on the level of HoldCo but not to engage in any (other) operational activities. This way, potential tax risks can be to some extent mitigated. In order to avoid HoldCo being dual tax resident in the US and Germany, it is important to show that HoldCo has its center of management in the US, which is easier if HoldCo only engages in a limited set of actions to begin with (we will come back to this important point, see Chapter A.III.3.2.).

These are the most common documents that German founders will encounter when doing the flip:

Corporate Docs

Action of Incorporator	One of the founders (or a representative such as US counsel) will in its capacity as incorporator: • appoint the designated board members; and • adopt the bylaws by virtue of an action of incorporator.
Charter	HoldCo will come into existence once the charter has been filed. Among other things, it states the authorized capital stock of the company.
Bylaws	The incorporator and the secretary of HoldCo (the secretary is one of the company's officers) will certify the bylaws of HoldCo.
Stockholder Consent	Founders/Founder HoldCos as future stockholders of HoldCo will approve the indemnification agreements and the stock plan.
Initial Board Consent	The board will appoint the officers by means of a written resolution and to grant its consent to the initial issuance of shares to the Founders/Founder HoldCos, the execution of indemnification agreements and other organizational matters.
Securities Exchange Agreement	Founders/Founder HoldCos will enter into a securities exchange agreement with HoldCo in which they will undertake to transfer all shares held by them in OpCo to HoldCo in exchange for shares in HoldCo.
Stock Restriction Agreements	Each of the founders/Founder HoldCos will enter into stock restriction agreements with HoldCo governing, inter alia, the founder vesting.
Share Transfer Agreement	The share transfer agreement consummates the transfer of all shares in OpCo to HoldCo as contemplated under the Securities Exchange Agreement under German law and must be notarized by a German notary.
Indemnification Agreements	See below under Chapter A.IV.2.2.

Stock Plan (ESOP)

Stock Plan and Accompanying Documents	See below under Chapter A.VI.

Sonstige

Application for EIN	HoldCo will need to apply for an Employer Identification Number (EIN) from the Internal Revenue Service of the US. The EIN is, *inter alia*, required for opening a bank account. The EIN can be applied for online if the application is made by a HoldCo representative holding a US social security number, EIN, or individual tax identification number (ITIN). If applied for online the EIN is issued immediately. Otherwise, the application must be made by mail or fax. Note that the issue of an EIN can in this case take several weeks. For details see Chapter A.III.1.2.4.
Section 83(b) Elections	See above under Chapter A.III.1.2.4.

2.1 How to Flip

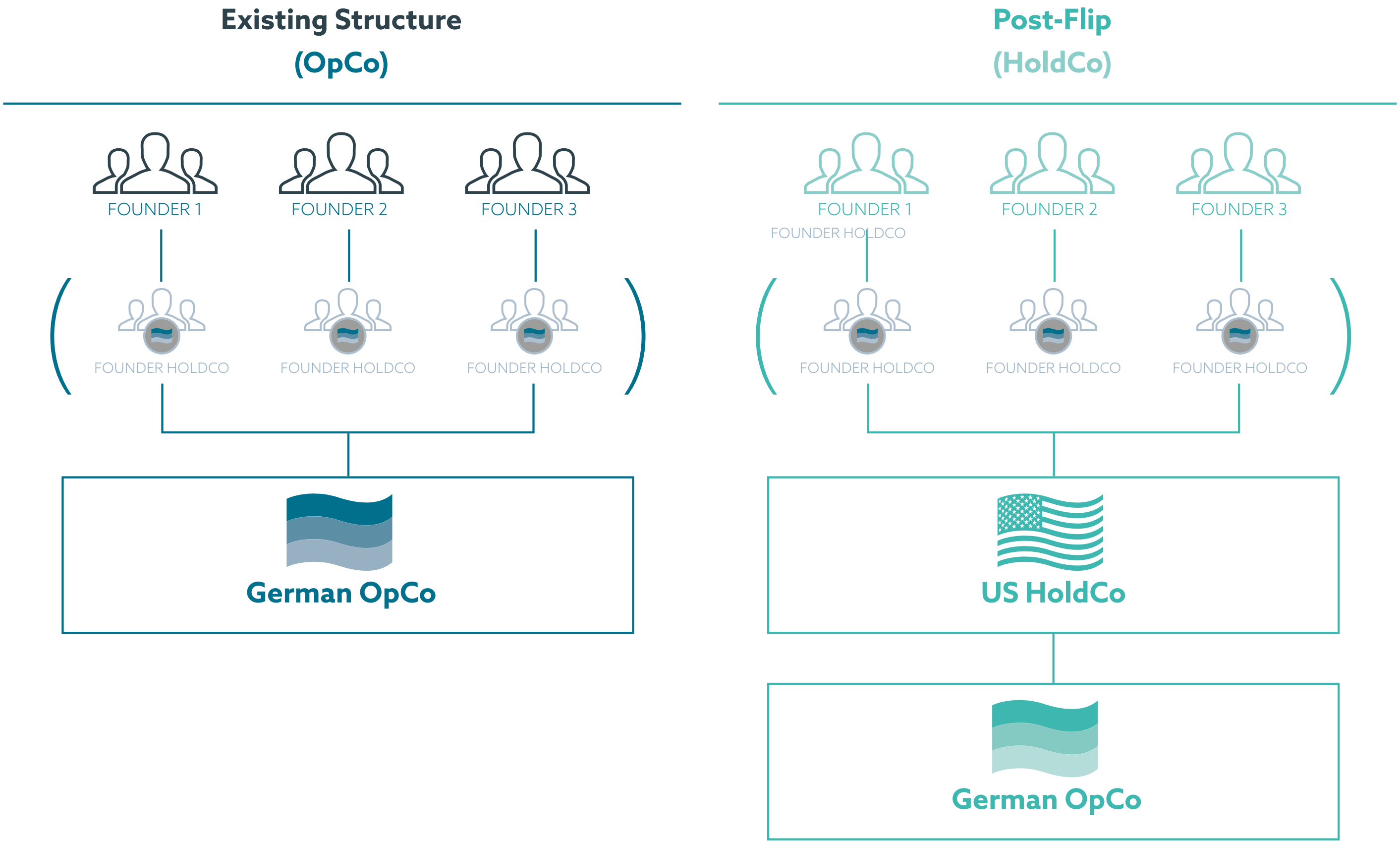
2.1.1 Overview

Here is a brief and simplified summary of the typical steps to be taken in a flip, though in the following Chapters, we will add some nuances. The best transaction structure will, however, always depend on the specific case at hand. Founders and investors are well-advised to bring an experienced counsel on board who can cover both the German and the US tax and corporate law angles.

Step 1: HoldCo is incorporated but does initially not issue shares to stockholders.

Step 2: The shareholders of OpCo (*i.e.*, the founders or their Founder HoldCos and, as the case may be, any existing investors holding shares (not convertible instruments)) commit to exchanging their shares in OpCo with shares of the relevant class of capital stock of HoldCo corresponding to the class of shares they hold in OpCo.

Step 3: The shareholders of OpCo transfer 100% of the shares in OpCo to HoldCo by entering into a share transfer deed with HoldCo to be notarized by a German notary. In exchange, HoldCo issues shares in itself to the shareholders of OpCo. Figuratively speaking, the shareholders exchange or "flip"/"swap" their shares in OpCo for shares in HoldCo, and OpCo is "shifted" under HoldCo thereby becoming its subsidiary.



2.1.2 Setting up HoldCo

For details regarding how to set up HoldCo please see Chapter A.III.1.2. above. The explanations given in that Chapter apply equally to a greenfield set-up or an actual flip transaction.

2.1.3 The Securities Exchange Agreement

Although OpCo could also transfer its entire assets to HoldCo (or a newly set up second OpCo as a subsidiary of HoldCo), it is more practical and customary for a flip that the shareholders contribute their shares in OpCo into HoldCo and, in return, receive shares in HoldCo. This way, OpCo continues as a going concern legal entity and the existing contracts with the employees, suppliers and customers can continue without interruption and no assets of OpCo need to be moved around.

To this end, the existing shareholders of OpCo acquire shares in HoldCo *pro rata* to their shareholdings in OpCo. Instead of paying in cash, they transfer their OpCo shares to HoldCo. The details are set out in the securities exchange agreement between HoldCo and the existing shareholders of OpCo, usually governed by Delaware law.

The share exchange as contemplated in the securities exchange agreement is consummated by having the shareholders of OpCo enter into a German law share transfer agreement with HoldCo notarized by a German notary which transfers the title in all shares in OpCo to HoldCo.

If OpCo has not yet issued preferred shares to investors prior to the flip and has, therefore, only issued common shares, its shareholders will exchange these for shares of common stock in HoldCo. However, in some cases, OpCo will already have received financing from business angels or early-stage VC investors in Germany before doing the flip. In this case, preferred shares in OpCo have been issued and the investors have been granted additional rights, *e.g.*, liquidation preferences, drag-along rights or certain veto rights. Because the shareholders will seek to maintain these preference rights, their shares must be exchanged for shares of preferred stock in HoldCo. These rights must, however, be aligned with the interests of subsequent US investors. Here, the founders and existing investors in OpCo should receive advice from an experienced US counsel who knows what is "market" in the US and what US investors will likely want to see in an upcoming financing round. It needs to be well considered whether it makes sense to spend time and money on mirroring the existing preference rights and governance of OpCo on the level of HoldCo really as much as possible if such legacy provisions will in all likelihood not square with the expectations of future US investors. Experience teaches us that it is often more cost-efficient to follow the prevailing standards in the US from the outset, *i.e.*, in particular use the NVCA standard documentation[10], rather than spending time and money to "carry over" all provisions from German investment and shareholders' agreements into HoldCo's corporate and financial governance. In the next financing round, especially when it will be led by a US investor, the standard NVCA provisions are then often reinstated as they are considered to be "market" by the incoming investor.

Against this background, let us have a quick look at some of the typical US (NVCA) agreements.

10. In our Guide OLNS#11 "Bridging the Pond", we give an introduction to the NVCA documentation and explain where NVCA deals differ from typical German market transactions. The Guide can be downloaded here: media.orrick.com/Media%20Library/public/files/insights/2023/olns11-bridging-the-pond.pdf.

2.1.4 Typical US (NVCA) Agreements

VC-backed US companies will usually feature the following documents (in practice, most of them are drawn up based on the NVCA template documentation which then gets adjusted on a case-by-case basis).

Certificate of Incorporation / Charter: The company's certificate of incorporation (also referred to as a charter) is the only publicly filed document of the five core documents presented here. The certificate of incorporation sets forth the bedrock principles governing the company, some of the rights and privileges vested with the preferred stock and, in particular, rights regarding dividends, liquidation preference, protective provisions and anti-dilution protection. When a new class of (preferred) stock is issued or the number of authorized shares is increased, these changes need to be reflected in the company's certificate of incorporation (that is why the filing of the amended and restated certificate of incorporation — usually with the State Secretary of Delaware — is an important first step in the closing of a US VC financing).

Stock Purchase Agreement: The new investors and the company will enter into a stock purchase agreement under which the new investors will purchase preferred stock. This stock purchase agreement will identify, among others, the number of shares of preferred stock being sold to the investors, the purchase price per share of preferred stock to be paid by the investors and the conditions to be satisfied prior to the closing of the financing transaction. It will also contain the representations and warranties given by the investors (a rather limited set of core corporate representations) and the company, the latter including the validity of the preferred stock being purchased and, in most cases, a rather extensive list of operational and financial representations and warranties. In a flip scenario involving existing preferred stockholders on OpCo level and no new investors coming in on HoldCo level this agreement would be replaced by an adapted securities exchange agreement as described above.

Investors' Rights Agreement: An investors' rights agreement grants certain rights to the investors, which typically include information rights, preemptive rights in case of future issuance of new securities and registration rights pursuant to which the investor can require the company to publicly register the company's common stock (and sometimes preferred stock) with the SEC in connection with or following an IPO of the company. Unlike in Germany, some of these rights are usually reserved for the larger investors, called the "major investors." The investors' rights agreement can also include relevant provisions around the founders' lockup, the company's employee stock option plan and board observer rights.

Voting Agreement: In a separate Voting Agreement, the parties stipulate how the stockholders will appoint and remove directors on the company's board of directors. These agreements usually also contain provisions regarding the stockholders' obligations to vote in favor of exit transactions (known as a drag-along), provided that certain criteria are fulfilled (*e.g.*, approval of the transaction by the board, a majority of common stock and a majority of preferred stock).

Right of First Refusal and Co-Sale Agreement: Finally, the parties may enter into a separate right of first refusal and co-sale agreement, which provides that if the founders or certain other holders of common stock propose to sell their shares to a third-party buyer, the company will have a primary right of first refusal and the holders of preferred stock (usually, this right is limited to the major investors) have a secondary right of first refusal to match the third-party offer or, alternatively, the holders of preferred stock have a co-sale right (also here, such right is usually limited to the major investors) to participate in the sale by selling their preferred stock to the third-party purchaser on a *pro rata* basis. Typically, in US financing rounds, the right of first refusal and co-sale obligations are imposed only on the founders or other key holders' shares as opposed to German financing rounds where the right of first refusal and co-sale obligations have in most cases to be observed by all stockholders (subject to certain exceptions).

WHERE TO FIND WHAT

The table below lists the main economic and control considerations that a comprehensive VC deal documentation will usually address (post the term sheet stage) and shows where such provisions can be found in typical German market documentation and where corresponding provisions can be found in the NVCA set of documents[12]:

Topic	In Germany, details can be found here	In the US, details can be found here
ECONOMIC TERMS		
Pre- and post-money valuation	Investment Agreement	Stock Purchase Agreement (in which the pre-money valuation is implied by the purchase price of the stock)
ESOPs, VSOPs and co.	Investment Agreement (to the extent such programs are relevant for the pre-money valuation) and shareholders' agreement (as it relates to the implementation, amendment and economic burdens of the program)	Stock Purchase Agreement (the size of the ESOP; details of the program are in the plan itself, as adopted by each company's board and stockholders)
Investment amount and issuance of new shares	Investment Agreement	Stock Purchase Agreement
Mode of payment as well as default provision	Investment Agreement	Stock Purchase Agreement
Secondary share sales	Investment Agreement (sometimes separate agreement)	Separate agreement
Representations, warranties and remedies in case of breach	Investment Agreement	Stock Purchase Agreement (with any necessary disclosures against the representations and warranties to be found in a separate "Disclosure Schedule" document)
Anti-dilution protection	Shareholders' Agreement	Certificate of Incorporation
Preference dividends	Shareholders' Agreement	Certificate of Incorporation
Liquidation preferences	Shareholders' Agreement	Certificate of Incorporation

12. The order in which the terms are presented in this table follows the structure of our publication, "OLNS#9 – Venture Capital Deals in Germany," which presents these topics in detail for German market VC financings and is available at https://media.orrick.com/Media%20Library/public/files/insights/2021/OLNS9-VC-Deals-in-Germany.pdf.

Topic	In Germany, details can be found here	In the US, details can be found here
CONTROL TERMS		
Board (composition)	Shareholders' Agreement and articles of association	Voting Agreement
Investor majority and investor veto rights	Shareholders' Agreement, articles of association and (as the case may be) the rules of procedure for the management	Certificate of Incorporation (protective provisions)
Investors' Rights Agreement (board matters requiring preferred director approval (if any))	Shareholders' Agreement	Investors' Rights Agreement
Information and monitoring rights	Shareholders' Agreement	Investors' Rights Agreement
Share transfer provisions	Articles of association (all transfers require at least shareholders' approval)	No equivalent (may be contained in the bylaws)
RoFR	Shareholders' Agreement	Right of First Refusal and Co-Sale Agreement
Drag-along	Shareholders' Agreement	Voting Agreement
Tag-along	Shareholders' Agreement	Right of First Refusal and Co-Sale Agreement
IPO-related provisions	Shareholders' Agreement (if any)	Investors' Rights Agreement
Founder vesting and leaver events	Shareholders' Agreement	These matters are usually addressed outside the aforesaid financing documents and usually found in so-called "Founders' Common Stock Purchase Agreement(s)" or "Stock Restriction Agreement(s)," as applicable
ESG and diversity covenants (as the case may be)	Shareholders' Agreement	Investors' Rights Agreement or side letters with the respective investors

2.1.5 Dealing with Convertible Loans

As explained above, following the completion of the flip the shareholder structure on HoldCo level should be identical with the one at OpCo prior to the flip. This means that as part of the flip any outstanding options to acquire shares in OpCo will also need to be exchanged for new options to acquire shares in HoldCo. A case in point are convertible loan financings of OpCo. After completion of a flip, all existing shareholders should become stockholders of the new parent company of the borrower (*i.e.*, HoldCo), which, in turn, then will hold all shares of the borrower (OpCo). This two-tier structure would become more complicated if the lender would then at a later stage still have a right to convert its loan into shares of OpCo. Also, from the lender's point of view, this may not be an attractive option if it has to be expected that a future exit will occur on the level of HoldCo and no longer at the OpCo level.

IMPLICATIONS FOR INVESTORS BENEFITTING FROM THE BAFA INVEST VENTURE CAPITAL GRANT

Investors in German start-ups who grant a convertible loan to the company can benefit from the so-called BAFA INVEST Venture Capital Grant for their investment. Pursuant to this program an investor can, subject to a number of requirements and subject to certain caps and limitations, receive amongst others a 15% subsidy on a convertible loan investment.

Such investors should be aware that following the flip and an "exchange" of their convertible loan against a convertible note or SAFE as described in this Chapter, their investment in HoldCo will no longer be eligible for the grant as they will thereafter be investing in a US company and the BAFA INVEST program requires a (direct) investment in a German entity. This means that any grants already paid out will need to be repaid and that their respective investment will no longer be eligible for any future grants (such as the exit grant (*Exitzuschuss*)).

The above applies *mutatis mutandis* for shares that the investor has acquired within the last three years; there is a general three years' period during which the conditions for the BAFA INVEST grant must be observed. For real shares, this period commences upon acquisition and in case of a convertible loan only upon the conversion event, *i.e.*, acquisition of the conversion shares.

Note that the above refers to the BAFA INVEST program only. Implications of a flip on any other grant or subsidy programs should be reviewed on a case-by-case basis.

While in practice situations differ and require a detailed analysis on a case-by-case basis, conceptually the "swap" of a convertible loan on the level of OpCo to an instrument convertible into shares of HoldCo can be implemented as follows:

- HoldCo first assumes all obligations of OpCo under the original convertible loan, including OpCo's obligation to repay the loan amount and any accrued interest thereon, by way of an assumption of contract with discharging effect for OpCo with the lender's consent and with effect as of the completion of the flip.
- Once effective, the assumption of all obligations of OpCo under the original convertible loan constitutes a contribution of HoldCo into the capital reserves of OpCo and is, thus, tax neutral for OpCo.
- Simultaneously with the assumption of contract but again effective only as of the date the flip is completed, HoldCo issues a convertible promissory note or a SAFE to the lender with a loan/purchase amount equal to the principal loan amount under the original convertible loan plus interest accrued thereon until the date the flip is completed and conversion terms (largely) consistent with the terms agreed in the original convertible loan.
- HoldCo and the lender agree that the loan/purchase amount agreed in the convertible promissory note/SAFE issued to the lender by HoldCo shall be paid by the lender not in cash but by cancelling the original convertible loan as well as forgiving HoldCo's obligation to repay the principal loan amount and interest accrued thereon (which it had assumed from OpCo).

WHAT IF NOT EVERYBODY PLAYS ALONG?

Sometimes lenders are unwilling to exchange their convertible loans made to OpCo for a convertible instrument at HoldCo level. Since most companies cannot repay the loan before the flip, such lenders should be treated with caution. If the company completes the flip without exchanging the convertible loan for a convertible instrument at HoldCo level, or without at least obtaining the lender's consent first, the lender may seek to exercise an extraordinary termination right and demand immediate repayment of the loan. Without an appropriate qualified subordination clause in the convertible loan agreement, this could expose the company to the risk of insolvency. Some lenders may also threaten to convert the loan into shares in OpCo in order to create nuisance value at this level. Sometimes lenders who lose their BAFA INVEST funding due to the flip demand better terms for their convertible instrument received in exchange at HoldCo level. When push comes to shove, start-ups should carefully consider the options available to them. Lenders must also be aware that a stake in OpCo could leave them out in the cold in the event of a later higher-level exit (*e.g.*, when HoldCo gets sold) and that special conditions for their convertible loan/SAFE at HoldCo level may have negative tax consequences for them as well.

2.1.6 Dealing with Existing VSOPs

Some OpCos will have already set up a virtual stock option program ("**VSOP**") at the time of the flip. So the question is, what to do with the existing VSOP? VSOP beneficiaries shall remain incentivized in the new corporate structure while at the same time no payment obligations under the VSOP should become due until there is a liquidity event at the level of HoldCo.

The most clear-cut way to deal with existing VSOPs in a flip is to terminate any virtual shares existing under the VSOP when the flip is consummated and to exchange them against options to purchase shares of common stock in HoldCo under a new US-style employee stock option program at the level of HoldCo.

However, factors like the valuation of OpCo prior to the flip, the number of already vested virtual shares and the mechanics of the existing VSOP can call for leaving the existing VSOP in place and to amend its existing terms instead in order to (largely) achieve the same economic outcomes.

Exchange of Virtual Shares for Stock Options on HoldCo Level: This restructuring of the existing employee participation is a bit more complex and usually includes the following steps:

- The VSOP beneficiaries enter into an agreement with OpCo regarding the cancellation of their outstanding virtual shares.
- In exchange, HoldCo issues options to purchase shares of HoldCo's common stock to the VSOP beneficiaries under its newly created stock plan. The number of stock options granted, the exercise price and vesting schedule of such stock options are (economically) largely consistent with the terms agreed in the beneficiary's original VSOP agreement.

Canceling existing virtual shares at OpCo level and issuing stock options at HoldCo level also offers the advantage of accurately reflecting legacy awards to beneficiaries under the VSOP in HoldCo's post-flip capitalization table.

There are good arguments that the exchange of virtual shares under the VSOP against stock options under a newly established employee stock option program on HoldCo level will not trigger German wage taxes if the respective employee does not have (at that point in time) a payment claim under the VSOP against OpCo (*i.e.*, the VSOP has not yet been triggered).

Amendment of Existing VSOP Terms: This approach foresees that the VSOP stays in place but that its terms are amended so that payment claims of VSOP beneficiaries are triggered by a liquidity event at HoldCo level (instead of a liquidity event at OpCo level; such a lower-level exit will become rather unlikely once the flip is completed). Such amendments will usually include the following:

- The definition of "liquidity event", "exit" or similar as a trigger for payment claims under the VSOP should align with the (deemed) liquidation events as defined in HoldCo's corporate documents from time to time.
- The payment claims of the VSOP beneficiaries under the VSOP will be derived from the value of one share of common stock of HoldCo (given the different denominations for common shares in OpCo and for shares of common stock in HoldCo this will require a formula). Thus, existing/legacy rights under the VSOP will need to be accounted for in HoldCo's (fully-diluted) capitalization table.
- While OpCo remains the principal obligor of any future payment claims of the VSOP beneficiaries under the VSOP, the HoldCo accedes to the VSOP between OpCo and the beneficiary as joint and several debtor of all payment claims of the VSOP beneficiaries alongside OpCo.

Such amendments should not give rise to German wage tax issues, provided that the VSOP has not yet been triggered and there are no existing payment claims against OpCo.

2.2 Anticipating a Future Flip

So, if a flip is a realistic option for a start-up in the near future, it may make sense to set up certain documents that are key for young companies in a way that makes the implementation of a flip easier down the road. This might include for example the following:

- Convertible loan agreements on OpCo's level can already take account of a flip restructuring. First of all, the convertible loan agreement should clarify (by a proper definition of the relevant trigger events) that a flip shall not qualify as an exit (as there is ultimately no change-of-control) and thus does not trigger any conversion or payment claims. In addition, a mechanism should then be provided on how the lender has to replace its convertible loan with the borrower against an economically equivalent agreement with the new parent company. In the ideal case, the convertible loan agreement will have the convertible instrument to be issued by a future HoldCo to the lender in a flip scenario annexed to the loan. This will, however, from a cost/benefit perspective usually only make sense in case of a more or less certain flip in the near future.
- Any employee participation program (usually, in Germany, these programs are set up as virtual, *i.e.*, not equity-based programs) on OpCo's level should give OpCo the unilateral right to terminate the program and exchange any existing claims thereunder for economically similar claims under an equity-based stock option program on HoldCo's level. To give OpCo a maximum degree of freedom, the virtual employee participation program should allow OpCo to maintain the program but to make necessary amendments following the flip, *e.g.*, amend the trigger event for payment claims under the program so that it now refers to liquidity events on HoldCo's level. However, the tax consequences of any amendment of or more comprehensive restructuring of an existing program should be examined on a case-by-case basis. Further, the participation program should be clear that a flip does not constitute an exit and does, thus, not trigger payment claims of the beneficiaries.
- Although in light of the potential tax consequences, some shareholders might be reluctant here, it might also make sense to include provisions in OpCo's shareholders' agreement that allow a (qualified) majority of shareholders to request the implementation of a flip and prevent to the extent possible any options for dissenting minority shareholders to drag their heels.

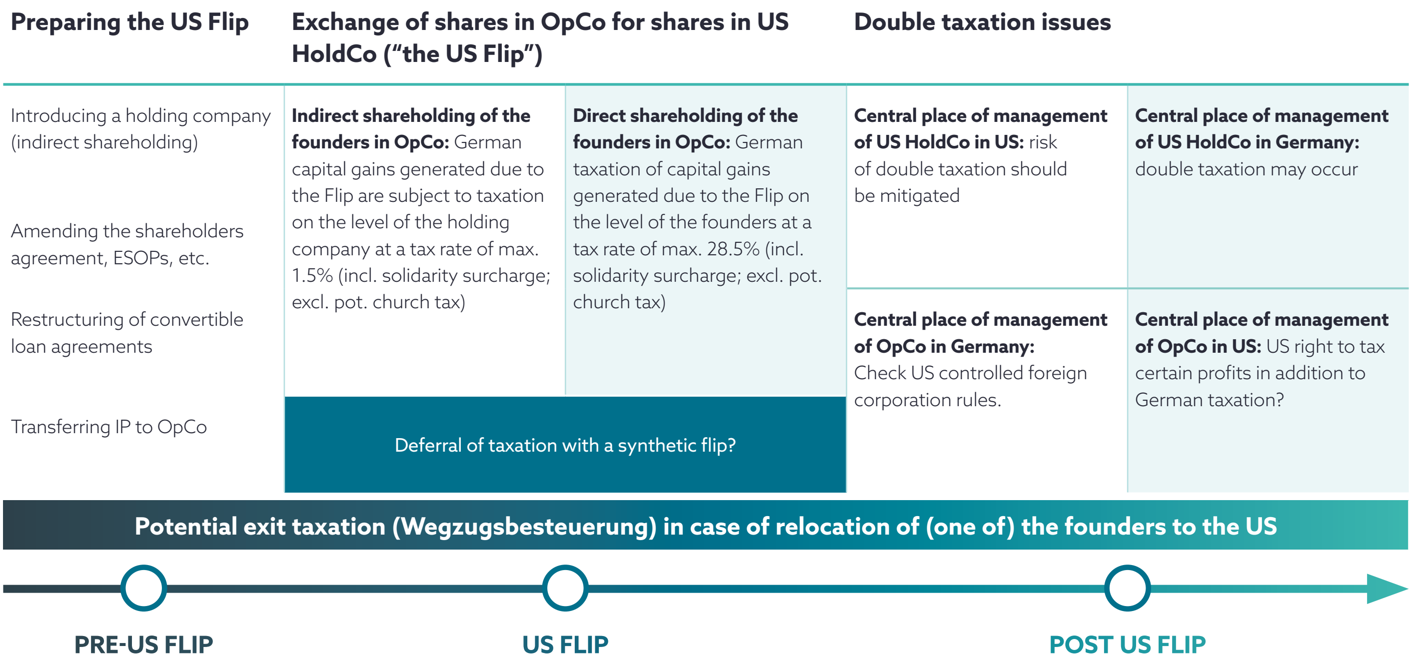
3. CERTAIN TAX CONSIDERATIONS

Now let's get to the Achilles' heel of many US/German holding structures – taxes.

> People who complain about taxes can be divided into two classes: men and women.
>
> *Anonymous*

Bear with us, we know this might initially appear mind-bogglingly difficult and opaque, but it is nevertheless important. The potential tax consequences of a US set-up must be analyzed and considered carefully. Detailed tax advice should be sought from experienced tax advisers for both the company and its shareholders based on the facts and circumstances of the individual case. Hence, in this Guide we limit ourselves to giving an overview of certain tax considerations from a 30,000 feet cruising altitude.

To provide some structure, we will first present tax consequences that are specific for a flip scenario before turning to tax considerations that apply both to a flip as well as to the establishment of the US holding structure from scratch.



3.1 Tax Consequences of a Flip

Unlike in case of a set-up from scratch, in a classic flip, OpCo is moved around, *i.e.*, its shares are transferred. Such transfer of shares in OpCo in exchange for shares in HoldCo triggers taxes and affects existing loss carry forwards. We will present the main considerations in the following paragraphs before briefly looking at the "synthetic flip", a reorganization based on a deferred flip that can sometimes help overcome the "dry income" problem of the flip (but at the cost of a higher tax burden down the road).

3.1.1 Capital Gains Taxation

The share swap underlying the flip is a taxable (sales-like) event under German tax law. Unlike for share swaps involving EU/EEA companies, a flip into a company organized under the laws of the US cannot be effected on a "no gain/no loss" basis and there is no rollover of acquisition costs under the German Transformation of Companies Tax Act (*Umwandlungssteuergesetz*) available.

Our (some might argue cynical, but still lovely) tax colleagues call this a "dry income" (sometimes also referred to as "phantom income"), *i.e.*, a situation where a taxpayer is required to report income (and pay taxes) but where no corresponding liquidity was actually received by that taxpayer.

Thus, when implementing the flip, the current shareholders of OpCo will record a gain (loss) at the balance of (i) the fair-market value (*gemeiner Wert*) of OpCo shares and (ii) their carrying book value and transaction costs, each at the time of transfer of title (or if differing, upon transfer of economic ownership) in OpCo shares to HoldCo.

For German income tax purposes, the determination of the fair-market value of shares in a non-listed company must primarily be derived from comparable sales that have occurred during the last year (these can be share issuances as part of a priced financing round or secondary share sales) or, in the absence of any such share sales or if the valuation cannot be derived from any such sale (no arm's length conditions, sale of shares of a different share class, etc.), from a valuation method customary in general business transactions for non-tax purposes. If this requires a valuation report, this report should be prepared by a professional appraiser. However, obtaining an appraisal is not a silver bullet. The tax authorities may question the valuation method and the assumptions of the valuation report (*e.g.*, in the course of a tax audit) and determine a deviating higher value of OpCo and thus a higher tax liability of its shareholders. The shareholders may then appeal against such a determination.

With respect to the effective tax burden, the situation differs based on whether the respective shareholder of OpCo that transfers its shares to HoldCo is

- a German corporation (such as Founder HoldCo); or
- an individual subject to German taxation.

Corporate Shareholder: For corporate shareholders, the regular German tax relief should often be available. Thus, 95% of any gain from the flip would be tax-exempt, with the remaining 5% increasing such corporate shareholder's taxable income. A loss would be fully tax-exempt (no tax relief). Depending on the local trade tax multiplier, the 95% tax exemption leads to an effective taxation for a German corporate shareholder at approx. max. 1.5% of the respective gain resulting from the flip. Just for completeness' sake: An exception to the rule of 95% tax exemption (with the consequence of full taxability of a gain from the flip and an effective tax rate of approx. 30%) exists for financial institutions, insurers and certain other enterprises with special business models in the form of a corporation (*Körperschaft*).

Individuals: In contrast to that, if the shareholder is an individual subject to German taxation and has been holding an equity stake in OpCo of at least 1% at any point in time in the last five years, their gain from the flip would only be 40% tax-exempt, with effective taxation often ranging up to approx. 28.5% (further increased by church tax, if applicable).

3.1.2 Loss Carry Forwards

OpCo might have relevant losses carried forward which are normally credited against any taxable profits of OpCo. However, under German law, subject to certain exceptions such as the "Untaxed Reserve-Escape" ("*Stille Reserven-Klausel*"), such losses carried forward will be fully forfeited if more than 50% of the share capital in OpCo is sold or otherwise transferred to a third party within five years. Thus, there is a significant risk that in case of a flip all losses carried forward will be forfeited. We can't go into details in this publication, but for completeness' sake please note that for some years now, German tax law has also provided the possibility to apply for a continuous use of such losses carried forward despite a transfer of the majority of shares to a third party (subject to certain conditions).

3.1.3 Deferred Exchange Agreement as Alternative – the Synthetic Flip

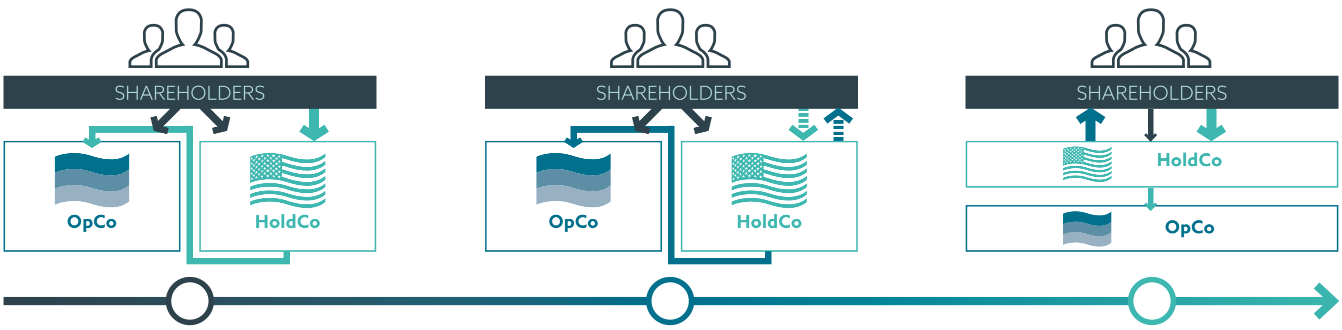
As we have seen, a flip may have severe tax consequences. If the taxes resulting from a full flip are considered too high at the relevant point in time given that without an imminent exit option the existing shareholders of OpCo might not have the necessary liquidity to pay such taxes, a potential alternative could be a so-called "synthetic flip." Such a synthetic flip is often implemented by way of a deferred exchange agreement that mostly postpones the (potentially significantly increased) tax burden to a later point in time (*e.g.*, to the time of an exit or other liquidity event).

Here is how it works in a nutshell:

- The shareholders of OpCo would initially contribute only a fraction of their shares into HoldCo but would otherwise remain shareholders in OpCo together with HoldCo. By limiting the initial contribution to a relatively small number of shares, the contributing shareholders will only realize a limited tax gain and the upfront tax burden can be minimized.
- The shareholders of OpCo enter into a deferred exchange agreement with HoldCo whereby the shareholders of OpCo agree to an exchange of all their remaining shares in OpCo for shares in HoldCo with such exchange to become effective immediately prior to an exit / liquidity event (or after a certain time period).

This is implemented by mutual call and put options between OpCo shareholders and HoldCo. Under German tax rules, these call and put options should not be exercisable at will and not overlap, but only in the event of an imminent exit/liquidity event or after a certain period of time. Such exchange agreement would need to be accompanied by a corresponding voting agreement for HoldCo.

The "Synthetic (US) Flip"



STEP 1:	STEP 2:	STEP 3:
Preparing for the "Synthetic (US) Flip": Setting up a (US) HoldCo.	The deferred exchange agreement: Conclusion of a conditional share exchange agreement ("**DEA**").	Execution: Immediately prior to an exit or liquidity event, DEA is executed.
Shareholders of OpCo transfer **only a fraction** of the shares in OpCo to HoldCo.	OpCo's shareholders agree to an exchange of all their remaining shares in OpCo for shares in HoldCo subject to the condition precedent of an exit or liquidity event.	Implementation of the DEA. Capital gains generated by the transfer of the remaining (majority of) shares in OpCo will be taxable in Germany, avoiding, however, dry income.
Taxation of capital gains generated by the transfer of (a fraction of the) shares.	**At that time: no actual exchange of shares and no (further) taxation.**	**(At least) for tax purposes: This is the main event.**

It should be noted that while a synthetic flip can delay the occurrence of the major tax event to some point in the future, it will in many cases ultimately increase the tax bill as often the fair market value of the shares in OpCo will (presumably) be higher when the flip is finally fully implemented (which, however, will occur at a time when the taxpayer will (hopefully) receive corresponding liquidity through the exit or another liquidity event). In addition, the transaction structure and the underlying documentation is more complex and a synthetic flip might be reviewed more critically by incoming investors due to its (presumed) higher transaction risks.

3.2 Tax Considerations for Every Two-Tier Structure

So while the dry income resulting from a share swap is only relevant for the situation where the US/German holding structure is implemented through a flip, there are various tax considerations that relate to the period after the two-tier structure has been set up and equally apply to set-ups from scratch as well as flips. In the following paragraphs we will first present some tax considerations on HoldCo level before turning to some tax considerations relevant for founders who want to move to the US.

3.2.1 Tax Residency of HoldCo

As we have seen, once the flip has been implemented, HoldCo will be a holding company with no operations and its sole asset (at least initially) will be its equity in OpCo. The question is which tax regime applies to HoldCo, *i.e.*, will HoldCo be considered a US or German tax resident? The fact that HoldCo is a US company and registered in Delaware is not alone sufficient to answer this question. Instead, German tax authorities will ask for HoldCo's central place of management (center-of-management). If the central place of management is in Germany, from a German tax perspective, HoldCo will be considered a German tax resident and thus be subject to German taxation.

This in turn may result in double taxation as the US tax authorities will regard HoldCo as US tax resident due to its status as a US entity irrespective of the place of its central place of management. The above might sound harmless, but it has substantive tax and other consequences so founders should pay close attention to this.

There is no bright-line test for determining where a company is centrally managed and controlled. Rather, the center-of-management-test is a holistic test over some time where the tax authorities will look at the locations from where management decisions have been taken. Let us repeat this: Tax authorities will look out for the location from where the majority of relevant management decisions will be taken on behalf of HoldCo. In determining that location, in practice, tax authorities will, *inter alia*, take into account criteria, such as the physical location of board meetings, the residence of directors, the location of offices and similar matters. These criteria are complex and should be reviewed in detail. To establish HoldCo's center-of-management in the US after the company's initial set-up the following can serve as a general guideline:

Limit HoldCo's Role: Where possible, it may be advisable to limit HoldCo's activities as much as possible, *e.g.*, to fundraising, issuance of equity incentivization to employees and partners, the administration of OpCo and potentially other subsidiaries and to the contracting of certain service providers necessary for the aforesaid activities.

Place of Decision Making and Documentation: Take all relevant decisions by Holdco's board and officers outside of Germany and, perspectively, ideally from US soil. Relevant decisions typically include (non-exhaustive list):

- board resolutions;
- decisive phase of negotiations with investors (and, in case of an operational HoldCo, customers and suppliers etc.);
- the signing of documents;
- the drawing up and approving of financial statements;
- the filing of tax returns; and
- the taking of other formal corporate actions for HoldCo.

Decisions are deemed to have occurred where the person taking the decision was physically located at the time of the decision. This also applies to decisions taken via Zoom or other online meeting tools. In case of a written resolution by the board of directors (*e.g.*, DocuSign or similar services), the German tax authorities would look at the place where the respective director signs the circular. Thus, if a director is based in Germany and unable to leave Germany for the relevant deliberation and adoption of resolutions, it should be considered to have that respective director abstain from the relevant decision-making process (if possible).

The place of the actual decision taking should be documented, *e.g.*, in protocols, or electronic documents and comprehensive travel itineraries for the directors and officers of HoldCo should be maintained.

It should also be considered to create long-term physical presence for HoldCo in the US (offices, including home offices, potential other sites) and, where possible, appointing US resident directors and officers.

Outside Tax Advice: A qualified tax advisor should be engaged to assist with bookkeeping and the preparation and filing of tax returns for OpCo and HoldCo. It is advisable to retain the same German tax advisor to review the abovementioned German residency questions for HoldCo on a recurring basis and in particular whenever there is a relevant change of circumstances and to assess whether or not HoldCo needs to file tax returns in Germany.

3.2.2 Exit Taxation for Founders

As part of the set-up of a US/German holding structure, the founders might decide that at least one of them should relocate and run the business from the US (remember, having such founder be appointed as director and officer of HoldCo helps addressing the center-of-management issue discussed above). However, if the founders leave Germany and move to the US, this may trigger exit taxation (*Wegzugsbesteuerung*). The consequence of an exit taxation is a fictitious sale of shares in corporations at their fair market value at the time of relocation in which the founder has held at least 1% of the nominal capital in the last five years (*e.g.*, shares in Founder HoldCo or in HoldCo itself). This means that hidden reserves become subject to taxation of up to 28.5% (church tax might come on top) at the founder's level.

Exit taxation occurs, *inter alia*, when an individual (founder), who was subject to unlimited taxation in Germany for a total of at least seven out of the last twelve years prior to the relocation, gives up his or her German residence and habitual abode (and thereby gives up his or her unlimited taxation in Germany).

Example: Two founders each hold a 50% share in their start-up. Their respective acquisition costs for the shares amount to EUR 12,500 (*i.e.*, 50% of the minimum capital amount that you have to commit when setting up a GmbH.) After several financing rounds, the start-up expands operations to the US. One of the founders, whose shares are worth EUR 1,000,000 based on the valuation of the latest financing round, plans to relocate to the Bay Area to help develop a credible "Silicon Valley story." The move from Germany to the US may trigger taxes at an amount of up to approx. EUR 280,000 (excluding church tax) even though no shares have been transferred at all. Note that this issue is usually not mitigated by holding shares through Founder HoldCo as the value of the shares in Founder HoldCo are derived from the value of the shares in the start-up.

However, the founder still has some options to avoid the exit taxation:

- The founder maintains a domicile (depending on the individual circumstances it might be sufficient to maintain a room in his or her parents' house while being in possession of the keys to it) or his or her habitual residence in Germany and keeps his or her center of life interest in Germany. The closer the relations to Germany are, the more feasible it may be to demonstrate that the founder really has not moved the center of life interest out of Germany. With the center of life interest still in Germany and depending on the destination country's double tax treaty with Germany, the founder may argue that taxwise he or she has not left Germany after all, and, hence, no exit taxation accrues (most notably, the US/German double tax treaty would follow that logic).
- In case there is no realistic prospect that the founder will maintain a German domicile or habitual residence as well as his or her center of life interest in Germany, the founder may
  - be reimbursed for exit taxation he or she paid if several conditions are met, *inter alia*, relocating back to Germany within seven years (or upon application max. 12 years);
  - apply for a deferral and waiver of exit taxation if several conditions are met, *inter alia*, relocating back to Germany within seven years (or upon application max. 12 years) and regularly providing securities; or
  - apply for a payment in seven yearly interest free installments if several conditions are met, *inter alia*, regularly the provision of securities.

Another issue to look at when a founder moves abroad is OpCo's central place of management (yes, these considerations are not only relevant for HoldCo but also for OpCo). If the place of management of OpCo is relocated to the US, the hidden reserves of its assets will regularly also be taxed at OpCo level (at least to the extent that Germany loses its right to tax them).

This can sometimes happen involuntarily, but it is less likely to happen if the company removes the founder from the executive director's post to a supervisory role and/or puts in place an additional manager who credibly makes the majority of management decisions for OpCo "at home."

Additional Considerations for Flips: In case of a relocation of a founder who holds his or her shares in OpCo personally (until the flip) and moves to the US shortly after the flip, exit taxation should regularly not accrue, as the hidden reserves are only taxed once (in this case due to the flip as explained above), *i.e.*, the relocation does not lead to double taxation of hidden reserves. Note that as set forth above the relocation may still lead to the accrual of exit taxes on the level of OpCo or Founder HoldCo, as the case may be. Exit taxation on each corporate level can be mitigated if a managing director is installed on these levels who will continue to act from German soil and the relocating founder exercises influence on these levels only through supervision and instructions as a shareholder.

4. GERMAN FDI RULES RULE…?

You may wonder now: "Are you serious?" A young start-up flipping into a US holding structure or getting set up from scratch in a two-tier holding structure can be of interest for the German regulators, notably under German foreign direct investment ("**FDI**") rules? Well, it can, under certain circumstances. While you may think this sounds like boring regulatory stuff, keep in mind that a violation of these rules can be a criminal offense, so it is kind of important. In this Chapter, we will equip you with some basic guidance on when German FDI rules can become relevant and how to navigate some pitfalls (as *Galadriel* once said: "May it be a light to you in dark places, when all other lights go out").

4.1 General Information

To give you an idea of what we mean when talking about Foreign Direct Investment Reviews (or "FDI control", as lazy people would say), the FDI regime serves the purpose of ensuring that a transaction is not likely to affect the public order and security of Germany. Sounds vague? Indeed, it is. This assessment, which will be ultimately made by the German Federal Ministry for Economic Affairs and Climate Action (*Bundesministerium für Wirtschaft und Klimaschutz*), may be subject to political decisions you will never be aware of (*i.e.*, it is highly likely that after you decide to make a filing, at the end of the procedure you receive a brief decision, the rest is silence).

To answer the question that is likely front and center for most of our readers: When can I skip this part?

FDI control does typically[14] not apply in case a non-German or non-EU investor acquires less than 10% of the voting rights in the German company. However, other than in cases of the synthetic flip we discussed above, a non-German and non-EU Investor (HoldCo) will acquire all shares in a German entity (OpCo).

In addition, the FDI regime can only come into play when OpCo is (meant to be) active in certain sectors as listed in the German Foreign Trade and Payments Ordinance, such as:

- manufacturing or developing of military goods;
- critical infrastructure and related software;
- cloud computing services;
- medical products or pharmaceuticals;
- goods which use artificial intelligence;
- motor vehicles or unmanned aircrafts;
- robots;
- IT products; and
- goods for wireless or wired data networks.

14. One should have in mind that so-called atypical control rights may kick in but let's keep such details for a separate edition of our OLNS. Not to say we are reluctant to explain this here already but as *Phoebe Buffay* (Friends) would say: "I wish I could but I don't want to."

These categories are applied very broadly. For example, even software theoretically capable of being used in critical infrastructure may be covered by the categories above. To avoid that any investment would lead to trouble with the authorities, in particular at a later point in time, it might in some cases be considered to apply for a statement of non-objection (while such a statement might take up to two months, it will provide legal certainty).

4.2 Exemptions

The law provides for certain exemptions, *i.e.*, even in cases where OpCo is active or will become active in one of the areas set forth above, this does not mean that the US/German two-tier holding structure can only be set up once the German regulator gave their thumbs-up. But a note of caution is called for, the rules around exceptions are rather complex and might require an in-depth analysis on a case-by-case basis. If this sounds like shameless self-promotion, we suggest you trust your instincts...

The Flip Road: As mentioned above, transferring all shares in an existing OpCo to HoldCo can be subject to German FDI rules. In this scenario, the otherwise available exemption of an internal group restructuring will not apply. This is because such exemption requires all parties involved (*i.e.*, OpCo and HoldCo) to have their headquarter located in the same country. You don't need lawyers to conclude that this is obviously not the case for a German OpCo and a US HoldCo.

Greenfield Set-up: So let us now turn to a scenario where there is not yet an existing OpCo but just an aspirational founder team eager to set up their US/German holding structure from scratch. While reading the categories of mandatory FDI control you might come across the point where you thought, "Yep, our products will be covered... that is once we're finished developing." The good news is that a real greenfield investment, meaning an investment in order to create a new operation or to develop a new project, is not covered by the German FDI regime.

So as of now for really new greenfield set-ups with no pre-existing OpCo or relevant IP, German FDI rules should not require a mandatory filing. But, wherever there is light, there is also shadow. The German Government is currently evaluating if such transactions should generally be covered by the FDI regime as well. The main purpose will be to prevent foreign companies from acquiring sensitive ideas even before any product is ready for sale.

IV. Operating in a Two-Tier Structure – Corporate Governance Basics

The path to successfully establishing a two-tier US/German holding structure and operating in both markets is paved with a number of legal pitfalls. Founders need to be aware of these roadblocks. After the two-tier structure has been established, founders have to navigate two complex legal systems that sometimes follow very different paths. In this and the following Chapters we want to highlight a couple of legal issues that according to our experiences many founders and investors of German tech companies will face.

1. US CORPORATE LAW BASICS AND MAIN DIFFERENCES BETWEEN A GMBH AND A US CORPORATION

Under US law, there are both close corporations and open (or public) corporations. Close corporations are not publicly traded and are instead "closely held" by a small group of shareholders, whereas the shares of public corporations are available to be traded on a public market. The German GmbH is most comparable to a close corporation. Nonetheless, from the perspective of a German entrepreneur, a few major differences between both company forms are worth noting.

Corporate Governance: The American corporate governance structure is rooted in the separation of ownership and control. The underlying idea can be summarized as follows – though we note that this obviously does not reflect the reality of many start-ups. While a corporation is typically owned by multiple stockholders, these stockholders likely lack sufficient knowledge and incentive to participate in the daily management of the business given their (often) small stake in the corporation. Therefore, it is more efficient to delegate management responsibilities to a small number of experienced professionals whose sole focus is to grow the business.

Against this background, in its purest sense, the US corporate governance structure is pyramidal in form. Stockholders occupy the base and are empowered to vote on major corporate actions and to elect members to sit on the board of directors. The next tier is the board of directors who serve at the pleasure of the stockholders and whose role is to develop corporate strategy and policy and to advise on management decisions. At the apex is the band of corporate officers. Generally, the corporate officers and agents are the individuals who run the day-to-day business operations and are appointed and subject to removal by the board of directors.

Unlike the two-tier corporate governance model used by certain jurisdictions outside the US (*e.g.*, Germany with its distinction between a management board (*Vorstand*) and a separate supervisory body (*Aufsichtsrat*) for its stock corporations (*Aktiengesellschaft*)), the single board corporate governance scheme adopted by US corporate law allocates primary control of the corporation to either one or multiple individuals who are collectively called a "board of directors." Legally required to act in the best interests of the stockholders, the board of directors supervises the corporation's business and affairs and is responsible for hiring corporate officers to manage day-to-day business operations (for details on the directors' duties and their role in US start-ups, please see Chapter A.IV.2.2.).

Financial Constitution: In terms of the companies' financial constitution, only a GmbH has a minimum share capital of EUR 25,000. A Delaware corporation, in contrast, has no minimum share capital but a so-called stated capital, which restricts distributions to the shareholders. Put simply, the stated capital is the sum of the nominal value of all shares that have been issued at the nominal value plus the consideration of shares that have been issued without a nominal value unless they are part of the surplus. Since the board of directors is responsible for the issuance of the shares, it is also at liberty to decide which part of the consideration is assigned to the stated capital and which to the surplus.

Furthermore, in case of a capital increase, the shareholders of a GmbH are generally entitled pursuant to statutory law to a subscription right (*Bezugsrecht*), under which they are able to subscribe for as many shares as they require to maintain their percentage share in the company without dilution (obviously, the financing documentation of many VC-backed German start-ups provides for certain exceptions from this general rule).

Under Delaware law, the capital can be increased without mandatory subscription rights. However, the major investors in a start-up will often insist that such subscription rights be included in an agreement between the company and other major investors.

Minority Protection: In addition, all shareholders in a GmbH enjoy various inalienable rights. For instance, they are entitled to comprehensive information rights vis-à-vis the company and are able to challenge any resolution of the shareholders' meeting. In contrast, the shareholder rights in a US corporation can be restricted to a much broader extent. Against this backdrop (and for a number of tax and other legal reasons), for example, equity-based employee stock option programs (ESOPs) are much more common in the US in comparison to Germany (where still the virtual participation programs prevail though some recent legislative reforms made equity-based programs at least somewhat more attractive) because the shareholders are, although gaining an interest in the company, exempt from those shareholder rights that could interfere with the company's management.

2. THE BOARD OF DIRECTORS – WHAT TO KEEP IN MIND

2.1 Differences between Board Concepts in a GmbH and a Corporation

"Boards" in Germany and the US: When looking at the corporate governance of a German company from an American perspective, one of the most fundamental differences is that US corporate law follows the one-tier approach while German corporate law follows the two-tier approach. This difference needs to be kept in mind when talking about the "board," which has a different meaning under German corporate law. A German GmbH must have a management board (*Geschäftsführung*), which is responsible for representing the company and running its day-to-day operations. In addition, a separate corporate body called an advisory board (*Beirat*) may be established to advise the management board and approve certain actions for which the management board requires prior approval based on the corporate documents applicable to the respective start-up (little excursus: In larger GmbHs, the establishment of a so-called supervisory board (*Aufsichtsrat*) as controlling body instead is mandatory; in such companies one would normally not find a voluntary advisory board in addition to the supervisory board). This is the two-tier structure: In Germany the managerial and the supervisory functions are separated and assigned to two distinct corporate bodies of which the advisory board is optional (though frequent in VC-backed German start-ups) while the supervisory board would be mandatory (though in German start-ups supervisory boards tend to be the rare exception).

The Role of the Board in the US: Delaware law requires that the business and affairs of the corporation be managed by or under the direction of the board of directors. Delaware boards have broad discretion to exercise their business judgment to determine how they will discharge this responsibility, including what responsibilities should be delegated to management. Importantly, the role of the board of a Delaware corporation is also regulated by aspects of the US federal securities laws and securities exchange listing requirements.

The principal functions of many boards include:

- reviewing and approving annual budgets, major strategies, plans and objectives of the company, including business plans and budgets;
- advising and instructing the company's management, especially its CEO, on significant issues affecting the company;
- monitoring the performance of management, evaluating the accomplishments of management and selecting and removing corporate officers (including the President and CEO);
- setting executive compensation;
- amending the company's charter and bylaws;
- approving capital raising activities;
- approving all grants of equity;
- approving material contracts;
- approving the company's incurring indebtedness (such as a convertible note financing or a credit facility);

- approving acquisitions, mergers or other extraordinary activities; and
- with respect to publicly traded companies and late-stage private companies, establishing and overseeing effective auditing procedures so that the board of directors will be adequately informed of the company's financial status (including selecting independent auditors and establishing audit committees when appropriate).

The board of directors is ultimately responsible for managing and overseeing the business and affairs of the company. The board of directors delegates the authority for managing the day-to-day operations to the company's management and corporate officers. With respect to publicly traded companies and late-stage private companies, the directors must make sure the company has adequate policies and guidelines in place to comply with applicable law.

The board of directors is a collective decision-making body. Individual board members do not typically take actions on behalf of the company. Actions or approvals must be taken at a meeting (by telephone, via videoconference or in person). A quorum must be present (usually a majority of the then-serving directors) for the board to act.

2.2 Different Standards of Liability and Indemnification

In this Chapter, we present first a general overview of duties that directors and officers and, to some extent, controlling stockholders need to observe in the US before turning to some start-up specific questions and discussing ways to mitigate the ensuing liability risks that are common in the US start-up ecosystem. In another publication we also took a deep dive on the specific challenges and liability risks that arise in a (distressed) sale of the company or an insider-led downround and refer our readers to that publication[16].

2.2.1 Duties and Obligations of Directors and Officers in a Corporation – an Overview

Delaware law maintains that directors, officers and, in certain instances, controlling stockholders owe fiduciary duties of care and loyalty to the corporation they serve and its stockholders.

Duty of Care: Directors and officers of a Delaware corporation have a duty to act with the "amount of care which ordinarily careful and prudent men would use in similar circumstances." Gross negligence is the standard by which the Delaware courts measure satisfaction of the duty of care; *i.e.*, a reckless indifference to or a deliberate disregard of the whole body of stockholders or actions that lack the bounds of reason. Therefore, prior to making a business decision, it is the directors' obligation to inform themselves of all material information reasonably available to them, take sufficient time (in their business judgment) to understand and consider relevant issues, and, if necessary, in their business judgment, obtain advise from experts (such as legal counsel and financial advisors) and officers.

As permitted by Delaware law, the certificates of incorporation of technology companies based in Delaware typically include a provision eliminating a director's personal liability for monetary damages due to a breach of the duty of care. An exculpation provision of this kind regularly leads to the dismissal of most lawsuits alleging a breach of fiduciary duty by the director in their personal capacity.

16. See our Guide OLNS#11 "Bridging the Pond". The Guide can be downloaded here: media.orrick.com/Media%20Library/public/files/insights/2023/olns11-bridging-the-pond.pdf.

Duty of Loyalty: Against the background that stockholders, who are the true owners of the corporation, are largely powerless with respect to the corporation's strategy and management, the duty of loyalty fulfills the directors' and officers' obligations to act in the best interests of the corporation and its stockholders. The duty of loyalty intends to protect the corporation from a director or officer "us[ing] their position of trust and confidence to further their private interests."

Duty of "Good Faith": Over the last decade or so, Delaware courts have debated whether the duty to act in good faith is an independent fiduciary duty or a component of the duties of care and loyalty. The most recent jurisprudence on the matter distinguished the "concept of good faith from the duty of care and duty of loyalty" and established good faith as an element of the duty of loyalty. The Supreme Court of Delaware has not explicitly defined good faith and instead chose to outline two categories of behavior constituting bad faith. The first category includes "fiduciary conduct motivated by an actual intent to do harm." Under the second category, bad faith is established when "the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." The latter category may be applicable in circumstances where a director's actions are more culpable than gross negligence without a traditional self-interest conflict.

FULFILLING THE DUTY OF CARE – SOME GENERAL GUIDANCE

To satisfy the requirements of the duty of care, the board of directors must engage in a deliberative process. This may include the following:

- Act with the deliberation that is appropriate under the circumstances and be sure to "do your homework."
- Read all background materials made available to the board of directors.
- Attend and be prepared for all board and (if applicable) committee meetings; participate actively in board and committee meetings, discuss the pros and cons of proposals and voice any concerns.
- Directors must inform themselves of all material information reasonably available to them prior to making a decision, including outside financial, legal, tax, accounting and other experts as appropriate. Directors may, in good faith, rely on records and reports of the company, experts, and professionals.
- Directors must take sufficient time to understand and consider relevant issues and ask appropriate questions. Inquire into areas that seem to merit concern or follow-up.
- Spend the time in deliberation appropriate to the magnitude of the decision.
- Ask probing questions to management and third-party experts.
- Become familiar with the company's business and management.
- Learn about and evaluate the existence and availability of alternatives.
- Carefully review and correct minutes of all board and committee meetings.
- Disclose conflicts of interest where appropriate.

Duty of Oversight: Directors have a duty to exercise care in overseeing that the officers are properly executing their assigned tasks. This duty of oversight derives from the duties of care and loyalty but is not recognized by Delaware courts as a fiduciary duty on its own. The Delaware Supreme Court has held that a director breaches his or her duty of oversight when he or she has "utterly failed to implement any reporting or information system or controls [or] ... having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."

Duty of Disclosure: Like the duty of oversight, the duty of disclosure is not an independent fiduciary duty but a subset of the duties of care and loyalty. Under Delaware law, directors have a fiduciary duty to "disclose all material information to stockholders when seeking stockholder action." (*e.g.*, such as in proxy solicitations or self-tender offers).

BOARD PROCEDURES – SOME GENERAL GUIDELINES

Here are some general best practices on how to prepare and conduct board meetings that should be observed to mitigate legal risks:

- Distribute copies of studies, agreements, reports and other key documents relating to proposed discussions to the directors in advance of meetings.
- Adjourn meetings and reconvene at a later time if the directors need more time to consider the issues presented or to review pertinent information.
- Be aware that in litigation directors are likely to be deposed about how meetings were conducted.
- Minutes of board meetings are the official record of the board's proceedings.
- Be thoughtful as to the creation and retention of documents, including notes and emails. Documents may be discoverable in litigation or government investigation. If you choose to keep notes of board meetings (or conversations) or if you make notations on the materials that you receive, ensure that they are factual, accurate, complete and free from editorial comments or statements which could be misunderstood when put out of context.

2.2.2 Liability Risks and Means to Mitigate Liability Risks

Business Judgment Rule and Entire Fairness Doctrine: A breach of any of the directors' or officers' fiduciary duties would enable the stockholders of the corporation (or any one of them) to bring a claim against the director or officer personally. Against the wide scope of these duties (that keep being developed and fine-tuned by the courts), US case law has established the business judgment rule as a safe harbor for directors and officers to prevent inertia for fear of liability risks. Under this rule, a director's action is deemed valid if the director has acted on an informed basis, in good faith, and in the true belief that his or her action was in the company's best interest. Delaware corporate law further stipulates that directors can rely in good faith on information, opinions, reports or statements from officers, employees, board committees' members or any other person (also outside the company's organization) regarding matters the director reasonably believes are within that person's professional or expert competence, provided that the person has been selected with reasonable care by or on behalf of the company.

While courts will, under the business judgment rule, not question the propriety of a director's decision unless an adverse party proves, by a preponderance of the evidence, that the director's decision involved a breach of fiduciary duty, it is important to note that in limited circumstances, judicial review of directors' decisions is heightened under (i) the so-called entire fairness doctrine or (ii) an enhanced scrutiny standard.

- If the adverse party successfully overcomes the business judgment rule presumption, the directors must prove the "**entire fairness**" of their actions. The court also applies the entire fairness standard of review when a controlling or dominating stockholder stands on both sides of a transaction or when a majority of directors are personally interested in a transaction. We have discussed a few cases of the entire fairness doctrine that are particularly relevant for VC-backed start-ups in another publication[18]. In a nutshell, recent Delaware court decisions have emphasized that there are two elements of an entire fairness analysis: Fair dealing and fair price. The fair price consideration requires that the price per share was the highest reasonably attainable price under the circumstances, while the fair dealing analysis considers the transaction's time, structure and manner. Delaware courts have placed the initial burden to demonstrate the fairness of a transaction on the company, but the burden shifts to the challenger if the company had established an independent committee of directors to evaluate the transaction or if the transaction was approved by a majority of the minority stockholders.
- **The enhanced scrutiny standard** of review is an intermediate standard that lies between the business judgment rule and the entire fairness doctrine and applies in the context of sale of control transactions or defensive conduct by directors.

Indemnification Agreements: Under certain circumstances, directors can minimize/limit their liability for breaches of fiduciary duties, and directors and officers can both enter into indemnification agreements with the corporation, pursuant to which the corporation will defend, at the cost of the company, relevant directors and officers against incoming claims.

18. In our Guide OLNS#11 "Bridging the Pond", we give an introduction to the NVCA documentation and explain where NVCA deals differ from typical German market transactions. The Guide can be downloaded here: media.orrick.com/Media%20Library/public/files/insights/2023/olns11-bridging-the-pond.pdf.

Indemnification means that the company reimburses the director or officer for costs incurred with claims arising out of his or her actions when serving the company. This is important so that the individual is willing to take reasonable economic risks. If a director had to bear all costs him- or herself, the director may be reluctant towards taking the necessary business decisions and that assumes that qualified and motivated people could be found to assume such important roles in a company in the first place given how – at least from a Continental European perspective – litigation trigger-happy the US is.

Customarily, indemnification agreements cover the following scope:

- **Third Party Proceedings:** The company indemnifies the director or officer against expenses, judgments, fines and amounts paid in settlement concerning actions that were brought by third parties.
- **Proceedings by or in the Right of the Company:** Because the directors' and officers' action might not only entitle third parties to damages, but the company might also suffer a loss, it is vital to also extend the indemnifications to costs arising from actions by the company or in its rights.
- **Success on Merits:** If the director was successful on the merits or otherwise in a defense of a proceeding by the company or a third party, the costs arising from this suit are also part of a customary indemnity clause (keep in mind that despite the numerous fee shifting exceptions according to the American Rule of Costs it is still the default that each party of a civil law litigation is responsible for paying its own attorney's fees).
- **Witness Expenses:** The director might also participate in another proceeding, *e.g.*, as a witness, so that corresponding costs should be covered as well.

A customary indemnification agreement – the standard published by the NVCA is widely used for directors of US start-ups – will also stipulate that the indemnity should be granted to the fullest extent permitted by applicable law. However, if the director's actions are not covered by this definition and he or she is therefore liable, the director can still be reimbursed by a D&O insurance policy taken out by the company.

Additionally, it is customary to grant the directors an advance of expenses. Under Delaware law, there is no right to an advance. But against the background that a director will often not be in the financial position to bear the costs of a proceeding him- or herself, it is advisable to include a respective clause. This provision should stipulate that the company is obliged to pay the advance in a specific period of time (*e.g.*, 30 days) after being notified about the action. To avoid uncertainty and disputes between the company and the director, we also recommend that the advance is granted irrespective of whether the individual director would be able to bear the costs or not.

3. CORPORATE OFFICERS

3.1 Introduction

As outlined above, HoldCo operates in its day-to-day business through its agents rather than its directors, and officers are the principal agents of a corporation. Officers receive their grant of authority from the board of directors and are appointed by board resolution.

Under Delaware law, corporations must appoint two officers but are not required to define any particular officer titles, though most young tech companies will get started by appointing a "President/CEO" and a "Secretary" who can be the same person. Companies doing business in California (even if incorporated elsewhere (like Delaware)) must have a President, a Secretary, and a Chief Financial Officer (again, one person can fulfill several or all of these roles).

19. Siehe das Musterdokument unter: https://nvca.org/model-legal-documents/

3.2 The Roles

3.2.1 President and CEO

The top management function is vested by the board in the President or CEO. Although some corporations appoint two separate individuals to serve as President and CEO (and there is no clear guidance as to which position would have greater authority), most early-stage corporations have one person serving in both capacities. The CEO reports directly to the board of directors and is responsible for executing the strategies set in place by the board and for overseeing the management and performance of all corporate agents. The CEO/President is also the face of the company and expected to sign most of the company's documents. In many corporations, the CEO also serves on the board of directors, often also serving as its chairperson (although there is no requirement to have a chairperson).

3.2.2 Secretary

Simply put, the Secretary is expected to maintain the organizational documents of HoldCo and must certify the validity of these documents for various transactions including any financings.

Little sidenote for our German legally minded readers (anyone else beware, we are going to talk about German notaries...): The Secretary is of particular importance for setting up a two-tier structure with a German OpCo: As mentioned above, both the incorporation of a GmbH from scratch and the flip transaction require the involvement of a German notary and the German commercial register. Each time HoldCo's President or CEO or any other agent of HoldCo acts on behalf of the corporation, the notary and the commercial register will require proof that such person is duly authorized to do so. Since a commercial register comparable to the register maintained in Germany does not exist on state or federal level in the US, such proof can be a pain to provide.

That's where the Secretary comes into play: German notaries and commercial registers will accept a notarized certificate of representation issued by the Secretary as proof of HoldCo's proper representation by its President and CEO or any other agent the Secretary confirms to be an authorized representative. But what if the CEO/President and the Secretary are the same person (remember, a corporation must have two officers, but they can be the same person)? Curiously enough, the Secretary can even confirm in his or her capacity as Secretary that he or she is authorized to represent the corporation in his or her other capacity as President and CEO, although in our experience such certificate will occasionally get rejected by the acting notary or commercial register and then a statement or opinion from outside counsel might be required.

3.2.3 Other Roles

A corporation can appoint a variety of further officers in different roles. The most common role other than the roles of President/CEO and Secretary is the Chief Financial Officer/Treasurer who can be put in charge of the corporation's finances. At later stages many technology companies also appoint a Chief Technology Officer or Chief Legal Officer.

V. Financing Aspects

After the two-tier structure has been set up and we have familiarized ourselves with the corporate governance rules for HoldCo, we want to take a closer look at a few financing aspects.

No matter how great a business idea is, one essential element of start-up success is its ability to obtain sufficient funding to start and grow the business. While we explained the particularities around US equity financings and the key differences to the German market practice in another publication[22], we will in this Guide concentrate on SAFE financings as the de facto standard for early-stage financings in the US.

THE ORRICK SAFE FINANCING TOOL KIT

We have put together a tool kit to give start-ups and investors the tools to quickly and simply lay out the terms upon which a company will raise funds via SAFEs. The tool kit is available here www.orrick.com/en/tech-studio/forms/SAFE-Financing-Toolkit

In the second part of this Chapter, we will address other initial practical issues that often come up in the first months after a start-up has been set up in a US/German holding structure.

1. FUNDING THROUGH SAFES

1.1 Introduction

"SAFE" stands for Simple Agreement for Future Equity. It was introduced in the US as a replacement for "traditional" convertible promissory notes (herein referred to as "convertible notes"[24]) and has become a popular means of fundraising for early-stage start-ups. Using a SAFE, an investor invests cash into a company in exchange for the promise of obtaining equity upon the initial closing of the company's next equity financing. The SAFE is a simple, one-document security with terms that are generally acceptable to start-up companies and their early investors and require little to no negotiation; though as we will see upon closer inspection, the landscape is a bit more nuanced and with SAFEs, dilution management can become a bit more tricky.

> We got YC's investment after the US-German set-up and immediately thereafter signed a SAFE with another investor. The possibility to take SAFEs as an investment simplifies the fundraising a lot and makes it super-fast.
>
> *Florian Bauer*, Co-Founder of kiteKRAFT, Inc.

SAFEs are most common before a seed round of funding. This is because start-ups can leverage SAFEs to quickly raise money without giving up too much equity (hopefully). SAFEs are less common for late-stage start-ups because they have likely already had several priced rounds and SAFEs typically involve lower valuations.

22. See OLNS#11, the Guide can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/2023/olns11-bridging-the-pond.pdf.

24. For a detailed insight into convertible notes, see our OLNS#2 https://www.orrick.com/de-DE/Insights/2019/09/Orrick-Legal-Ninja-Series-OLNS-2-Convertible-Loans-for-Tech-Companies

Only introduced by Y-Combinator in 2013, in a little more than a decade, SAFEs have revolutionized the landscape of US early-stage financings. The predominance of SAFEs is underscored by some recent data published by the service provider *Carta*. According to that survey, a staggering 89% of all pre-seed funding (defined here as any raise under USD 1,000,000) flowed through SAFEs in Q4/2023 while convertible notes were still somewhat more prevalent in sectors like BioTech, MedTech and Energy (approx. 30%). Although the trend towards larger SAFEs is still intact, start-ups tend to shift to priced rounds instead of using SAFEs when the size of the financing round is about USD 3,000,000 or higher.

According to our experience, SAFEs are also gaining popularity in non-US jurisdictions such as the UK and France. While there were some attempts to adjust SAFEs for use in the German market to finance start-ups set up as a GmbH or UG (haftungsbeschränkt), such SAFE financings are still a rare occurrence. This is mainly because all shareholders of the company must usually be asked to sign convertible instruments in order to make sure conversion rights are enforceable. There are also uncertainties as to the correct accounting of "German SAFEs" as debt or as equity eliminating some of the key considerations for choosing to raise funds through SAFEs, *i.e.*, speed and simplicity.

1.2 SAFEs and Convertible Notes

Before SAFEs were introduced, early-stage start-ups widely used convertible notes to raise capital before their first equity financing. A convertible note is a debt instrument which is a debt obligation of a company before it is converted into preferred stock of the company at the company's next equity financing. Such financing must occur before the maturity date of the convertible note or otherwise it will need to be repaid (unless the term of the note is extended). Compared to issuing shares of preferred stock, which involves complex equity financing documents, convertible notes are simpler and cheaper to negotiate and issue. However, issuing convertible notes still requires the parties to enter into and negotiate a promissory note purchase agreement and the underlying convertible note (including an interest rate and the term of the note). Although these documents are less complex than equity financing documents, they still take time to negotiate and finalize before a company can accept investment from its investors (there is no universally accepted standard document for a convertible note like there is for a SAFE).

Unlike a convertible note, a SAFE is not a debt instrument but treated as an equity instrument without any interest rate or a maturity date.

> But you know what the funniest thing about Europe is? It's the little differences. I mean, they got the same shit over there they got here, but it's just, just, there it's a little different.
>
> *Vincent Vega*, Pulp Fiction (1994)

SAFEs are generally more aligned with the interest and intent of a start-up company and its investors regarding their investment. Because convertible notes are debt instruments, the parties must negotiate an interest rate and set a maturity date for the notes, by which time the company has to consummate an equity financing to cause the notes to convert, otherwise the notes will become due and payable. A start-up and its convertible note investors rarely consider their investment a loan to the company. Instead, they consider the investment a prepayment of the respective investor's future equity investment into the company. Due to the uncertainty of the timing that a start-up may be able to close its equity financing, both the company and its convertible note investors would have to keep track of interest accrued under the convertible notes and, as the case may be, extend the maturity date of such notes so that the company's next equity financing will occur before the maturity date. This is to ensure that the convertible notes will convert into the company's preferred stock without becoming due and payable.

The accrued interest (which, depending on the interest rate and the time a convertible note remains outstanding, may be substantial) will also increase the conversion amount and result in greater dilution to the founders.

In comparison, the terms for a SAFE are relatively simple and straightforward and often the only items that need to be negotiated are the discount rate and/or valuation cap (plus, as we will see, occasionally the terms of a lean side letter). An additional benefit of using SAFEs is that instead of trying to coordinate a single close with all investors, companies using SAFEs can close with an investor as soon as both parties are ready to sign (in practice, SAFEs are signed by using digital tools such as DocuSign).

In the seed stage, with SAFEs You can only Raise as much as You Really Need for the Next Milestone

A conversation with Dr. Patrick Großmann, CEO of Invitris

Orrick: Hi Patrick, in one sentence, what does Invitris do?

Patrick: We help other companies to develop protein-based drugs.

Orrick: Wow, an exciting life science topic. You made the flip with your GmbH early on…

Patrick: Yes, we were accepted by the Y-Combinator about two months after we were founded and then we did the flip straight away. In hindsight, we might have saved ourselves some costs and effort if we had waited just a little longer or started with an Inc. without running it operationally. But we wanted to rent laboratory space at the time, so we needed a company and so did set up a limited company directly. Fortunately, with individual founder holdings….

Orrick: Looking back, what was the biggest advantage of your structure and what were the biggest pains when setting it up?

Patrick: Both have to do with finances. Which should I start with, the benefits or the pains?

Orrick: As good lawyers, we naturally want to hear about the negative experiences first.

Patrick: At the time of the flip, we had taken out some convertible loans with our German company. We had to take them up a level and exchange them for SAFEs.

Orrick: And there were problems?

Patrick: In the end, we got all the convertible loan lenders on board, but we could have done a better job in explaining what happens upfront. SAFEs and convertible loans are not quite the same after all. But if you try to adapt relatively small SAFEs so that they reflect every detail of a German convertible loan as accurately as possible, then you're really only making the lawyers happy. No offense meant…

Orrick: No offense taken, but the point is understood. You have to make the case that you end up with an instrument that is essentially the same economically at the Inc. level, but you don't want to throw the big advantages of SAFEs overboard; which is speed and simplicity.

Patrick: Exactly, and that brings us to one of the main advantages of our Inc. We are still in the early phase and Y-Combinator taught us how important it is that in the really early stages you ideally only raise the amount of funding you need to reach the next milestone on your trajectory. This can be significant hires, technical progress, a better product/market fit, etc. With each of these milestones, you can continuously push for a higher valuation or higher caps. This reduces dilution for the founders. With SAFEs, such more frequent and moderate financings can be easily implemented.

1.3 SAFE isn't SAFE – Post-Money SAFEs and Pre-Money SAFEs

Over the years, more and more early-stage companies started raising larger amounts of capital using SAFEs, turning SAFE-based financings from shorter-term bridge financings into a substitute of what used to be priced seed financing rounds. In response, in late 2018, Y-Combinator revised the SAFE conditions and introduced the "post-money SAFE." This version of a SAFE treats all SAFEs and any other convertible notes or equities issued by a company prior to its next equity financing as one independent seed round with a pre-determined post-money valuation. Since then, the original SAFEs have often been referred to as the "pre-money SAFEs."

While today both pre-and post-money SAFEs are used, post-money SAFEs are dominant. An analysis done by *Carta* on its data set showed that of all SAFEs entered into in Q4/2023, 80% were post-money SAFEs.

Different Kinds of SAFEs

While the distinction between a post-money and a pre-money SAFE is key, one also needs to understand that both versions of the SAFE come in a few varieties, being:

- with a valuation cap but without a discount;
- without a valuation cap but with a discount;
- with a valuation cap and a discount; and
- without a valuation cap or a discount, but with a most-favored nation clause.

Founders need to understand the economic difference between pre- and post-money SAFEs. Notably how pre- and post-money SAFEs state the applicable valuation caps and how that affects conversion mechanics.

A pre-money valuation and a post-money valuation generally describe the same valuation of the company at two points in time, *i.e.*, before (pre) and after (post) the company has received the relevant investments. Hence, whether the company is raising USD 2,000,000 on a USD 8,000,000 pre-money valuation or USD 2,000,000 on a USD 10,000,000 post-money valuation results in the same economic outcome in terms of investor ownership (that is Latin for founder dilution) if (and that "if" is important) the company has not issued any prior SAFEs or convertible notes and does not do so until the SAFE converts in the next equity financing.

What founders need to be aware of is this: Remember that we said that the post-money SAFE treats all SAFEs and any other convertible notes or equities issued by the company prior to its next equity financing as one independent seed round. This is why the standard post-money valuation cap states the valuation after not only the funds raised with the respective SAFE but after all of the funds raised through SAFEs/convertible notes whether before or after the particular SAFE.

So here is how pre-money and post-money SAFEs calculate the conversion price applicable to the SAFE (in both instances, this calculation is done without factoring in the equity financing round in which the SAFE converts).

Conversion Price =

Pre-Money SAFE	Post-Money SAFE
Pre-money valuation cap / pre-money company capitalization	Post-money valuation cap / post-money company capitalization

The company capitalization in the pre-money SAFE does not include the shares issued upon conversion of SAFEs or other convertible instruments (*i.e.*, it is "pre" SAFE shares). By contrast, the company capitalization in the post-money SAFE includes all shares issued upon conversion of SAFEs. This means that SAFEs with a post-money valuation cap will not be diluted by other SAFEs/convertible notes and will only be diluted by the equity financing in which they convert while pre-money SAFEs are always diluted by other SAFEs/convertible notes issued prior to the next equity financing. Consistent with its approach to treat all SAFE/convertible note financings as one independent seed round a post-money valuation cap includes the existing option pool but not the pool increase that may be agreed for the equity financing in which the SAFE converts. Hence, SAFE investors are not diluted by the option pool existing immediately prior to the equity financing but are diluted by a pool increase agreed in the course of the equity financing. Under the pre-money SAFE, the calculation includes the full option pool, even if the options haven't been allocated, as well as the increase to the option pool occurring in connection with the equity financing, an unknown variable at the time of SAFE investment.

Investing on a post-money valuation cap SAFE allows investors to calculate their ownership in the company immediately prior to the equity financing and founders to calculate their dilution much more precisely as was the case under the reign of the pre-Money SAFE (a benefit that comes at the cost of higher founder dilution in case the company raises further SAFEs or convertible notes prior to the equity financing).

Example: Let's calculate a (simplified) example to illustrate the different outcomes of a pre- and post-money SAFE:

Scenario 1 – Pre-Money SAFEs: Let's assume the following:

- HoldCo has two founders (Founder 1 and Founder 2) who each hold 5,000,000 shares of common stock in HoldCo (through their Founder HoldCos). For simplicity's sake, we ignore any employee stock option programs and assume that the company has a total capitalization of 10,000,000 shares.
- Investor 1 invests now USD 500,000 into HoldCo via a SAFE with a valuation cap of USD 5,000,000 but no discount. Investor 2 chips in another USD 800,000 under the same conditions.
- HoldCo then raises a priced round of USD 1,500,000 from Investor 3 at a USD 12,000,000 pre-money valuation.

Let's assume that Investor 1 and Investor 2 used a pre-money SAFE. For them, the conversion price relevant for their SAFEs is calculated as follows:

Pre-money valuation cap / pre-money capitalization

The pre-money valuation cap under the SAFE becomes relevant, as the company raises its equity round at a higher valuation. The company's capitalization is its total number of shares before the new financing round and excluding all SAFE investments to be converted, *i.e.*, 10,000,000 shares. Thus, the conversion price amounts to USD 5,000,000 / USD 10,000,000 = USD 0.5 per share. Hence, Investor 1 receives for its USD 500,000 SAFE investment a total of 1,000,000 shares in HoldCo, while Investor 2 snaps up a total of 1,600,000 shares for its USD 800,000 investment.

As each SAFE impacts the other, only at this stage can our investors determine their ownership percentage in HoldCo's equity before the priced round takes place. With a total capitalization of 12,600,000 shares (remember 10,000,000 shares held by the founders, 1,000,000 shares held by Investor 1 and 1,600,000 shares held by Investor 2) this translates to:

Party	Number of Shares	Ownership Percentage
Founder 1	5,000,000	39.68%
Founder 2	5,000,000	39.68%
Investor 1	1,000,000	7.94%
Investor 2	1,600,000	12.69%

Both founders and SAFE-investors now get diluted through the equity financing from Investor 3. The equity financing is based on a share price to be calculated as follows:

Pre-money valuation / company capitalization

In practice, the company capitalization number is usually calculated on a fully-diluted basis including the shares to be issued under the SAFEs. The resulting purchase price for Investor 3 is USD 12,000,000 / 12,600,000 shares = USD 0.9524 per new share. Thus, Investor 3 will receive a total of 1,574,968 shares.

With a total capitalization of 14,174,968 shares, the parties' ownership stakes look as follows:

Party	Number of Shares	Ownership Percentage
Founder 1	5,000,000	35.27%
Founder 2	5,000,000	35.27%
Investor 1	1,000,000	7.06%
Investor 2	1,600,000	11.29%
Investor 3	1,574,968	11.11%

Scenario 2 – Post-Money SAFEs: Same example as above but Investor 1 and Investor 2 now use post-money SAFEs. Let's assume that Investor 1 agrees with HoldCo on a post-money valuation cap of USD 8,000,000 and Investor 2 has a SAFE with a post-money valuation cap of USD 10,000,000.

With the post-money SAFEs Investor 1 and Investor 2 have locked in the following percentages for their SAFE conversion:

- Investor 1: (USD 500,000 / USD 8,000,000) = 6.25%.
- Investor 2: (USD 800,000 / USD 10,000,000) = 8%.

When Investor 3's investment triggers the conversion of these two SAFEs, Investor 1 and Investor 2 get their ownership percentages as calculated in the previous step. Here, the SAFEs do not dilute each other when converted. To give Investor 1 and Investor 2 together a total of 14.25% HoldCo, HoldCo's total capitalization will have to be increased to

$$10{,}000{,}000 / (1 - 0.1425) \approx 11{,}661{,}807 \text{ shares.}$$

The resulting cap table will look as follows:

Party	Number of Shares	Ownership Percentage
Founder 1	5,000,000	42.875%
Founder 2	5,000,000	42.875%
Investor 1	728,863	6.25%
Investor 2	932,944	8%

Enter Investor 3 and the priced financing round. The price to be paid by Investor 3 is calculated as HoldCo's pre-money valuation of USD 12,000,000 divided by the fully-diluted capitalization (including SAFEs):

USD 12,000,000 / 11,661,807 = USD 1.029 per share.

This means that Investor 3 will get for its investment of USD 1,500,000 a total of 1,457,726 shares and the total capitalization will increase to 13,119,533 shares. The resulting cap table will look as follows.

Party	Number of Shares	Ownership Percentage
Founder 1	5,000,000	38.11%
Founder 2	5,000,000	38.11%
Investor 1	728,863	5.56%
Investor 2	932,944	7.11%
Investor 3	1,457,726	11.11%

A post-money SAFE gives more clarity and provides more certainty to investors and founders as they can know the ownership percentages in relation to other stakeholders right away before the new financing round that triggers the conversion. However, this statement needs to be somewhat qualified as in our example the Founders as well as Investor 1 and Investor 2 will get again diluted by the equity investment by Investor 3. As the priced round triggering the conversion of the SAFEs is an unknown, investors under a post-money SAFE will not know for certain the percentage they will own after this event takes place. However, they will still have more certainty regarding their ownership than when pre-money SAFEs are used.

1.4 Other Typical Provisions in SAFEs

As explained above, one of the main reasons why SAFEs are so ubiquitous is that they come in a standardized form that besides the choice between the pre-money and post-money version usually only requires very little negotiation of the following items.

Valuation Cap: A valuation cap ensures that the SAFE converts into shares of preferred stock in the company's next equity financing at a maximum price while it does not guarantee that the investor will in any case convert at a price lower than the price paid by the new cash investors. The capped price is calculated by dividing the (post- or pre-money) valuation cap by the company's capitalization immediately prior to the equity financing. If the capped price is lower than the price per share paid by the new cash investors of the equity financing the SAFE will convert based on such capped price into shares of a shadow series (the "**SAFE Preferred Stock**") of the preferred stock that is issued at the next equity financing to new cash investors ("**Standard Preferred Stock**"). If the valuation of the equity financing is less than or too close to the agreed valuation cap and, thus, the capped price is equal to or higher than the price paid by the new cash investors, the SAFE will convert into Standard Preferred Stock at the same price paid by the new cash investors.

Discount Rate: A discount ensures that the SAFE converts into shares of preferred stock in the company's next equity financing at a price that is lower than the price paid by the new cash investors while such discounted price is uncapped. The discount is applied to the per share purchase price of the Standard Preferred Stock paid by the new cash investors and the SAFE converts into SAFE Preferred Stock in any case. Discounts usually range between 10% and 25% and within our experience 20% being the norm in many sectors.

With a discount (and a valuation cap), the SAFE investor seeks an adequate compensation for the higher risk of investment that SAFE investors take when investing in an earlier stage than the investors investing in the next equity financing. A SAFE with both a valuation cap and a discount rate will ensure that the investor will in any case get a better deal than the new cash investors by capping the price if the round's valuation turns out high or applying a discount on the round price if the valuation falls short of the valuation cap.

In a most recent *Carta* study of SAFEs from Q1/2023 to Q1/2024, more than half of the analyzed SAFEs have a valuation cap (54%) or a valuation cap and discount (35%). When there is a discount present in the terms, it is overwhelmingly 20%.

MFN Provision: A SAFE can also include a most-favored nation (or simply "MFN") provision. If a company issues a SAFE with an MFN provision and later issues additional SAFEs with provisions that are better than those in the first SAFE (*e.g.*, higher discount or lower valuation cap), the first SAFE will be amended to include the better provisions at the investor's request. Uncapped, no discount, MFN-only SAFEs are often used in cases in which the terms of an equity financing have been agreed but the company needs funds immediately before the equity financing can close.

***Pro Rata* Right:** The standard post-money SAFE does not include a default *pro rata* right. While *pro rata* rights are usually not offered to all investors in SAFE financings, the company and the investor can agree in a separate side letter to grant the investor *pro rata* rights that usually only apply to the equity financing in which the SAFE converts and allows the SAFE investor to maintain its ownership stake in the company. For post-money valuation cap SAFEs, there is a standard *pro rata* side letter published by Y-Combinator which is widely accepted in the market.

1.5 Can the Company Sell SAFEs to Anyone?

The first thing that a US company (such as HoldCo) needs to understand about issuing securities (including selling SAFEs) is that in the US, the federal and state governments regulate the issuance of securities. The federal government, for instance, requires a company to share a lot of information with the public if it wants to issue securities, subject to certain exceptions. The most popular exception used by tech start-ups, Rule 506, allows a company to issue securities to preexisting contacts (*i.e.*, no widespread communication about the offering) who are accredited investors (*i.e.*, wealthy and high-income individuals, investment funds and the founders themselves; there is no formal "accreditation" process required).

Amongst the wide variety of further exceptions provided in federal securities laws, German founder teams should have heard of "Regulation S" given its relevance in the cross-border context. Regulation S provides an exemption from registration requirements of US securities laws for issuers to offer and sell securities that are considered "outside the US." The safe harbor provided by Regulation S generally requires (amongst others) that the offer to sell securities is made to a person outside the US and that the buyer is outside the US at the point of time the purchase takes place.

2. CHANNELING FUNDS TO OPCO

Once HoldCo has raised financing (be it through SAFEs or a priced financing round), the question arises how such funds can be channeled to OpCo. As in most cases, OpCo will employ the start-ups employees and develop its technology and services, this is where the bulk of the costs will be incurred.

In practice, there are in particular the following two options to transfer funds from HoldCo to OpCo.

Payment into the Free Capital Reserve: This is the simpler and, in our experience, also the more common option for early-stage start-ups. Here, the funds are transferred from HoldCo to the OpCo and booked in the free capital reserves of OpCo pursuant to sec. 272 para. 2 No. 4 German Commercial Code (*Handelsgesetzbuch*). From OpCo's perspective, the payment is considered a contribution by its sole shareholder HoldCo. For tax purposes, such contribution should be documented. To do so, it is sufficient if HoldCo adopts a shareholder's resolution at the level of OpCo. Such resolution has no specific form requirements. The contribution does not require the increase of the registered share capital of OpCo.

The contribution is regularly tax-neutral on the level of OpCo if the payment is not deducted from HoldCo's taxable income as operating expense or otherwise.

Grant of a Shareholder Loan: In this case, HoldCo will make the funds available to OpCo by way of an interest-bearing loan.

In the (often times unprofitable) early stages of a start-up, the advantages of a contribution may outweigh in many cases the advantages of a shareholder loan. Furthermore, as soon as the start-up approaches the profit zone, it may consider a restructuring of its financing.

However, in the early stages of a start-up such tax considerations will often not be relevant. In addition, the interest on the level of HoldCo can lead to interest income on OpCo's level. The start-up should also consult its tax advisor in this respect.

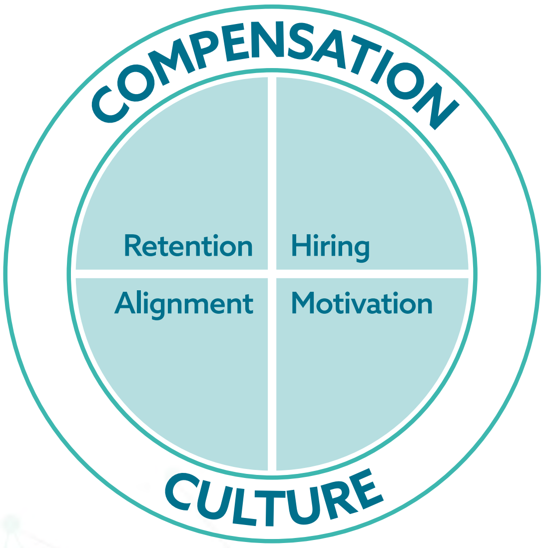
NOTIFICATION REQUIREMENTS TO REMEMBER

OpCo is obliged to: (i) submit a payment report if it receives a payment of more than EUR 12,500 from a foreigner (including HoldCo) or for the account of a foreigner from a resident or makes a payment to a foreigner or for the account of a foreigner to a resident; (ii) submit a stock data report on cross-border equity investments amounting to 10% or more of the capital or voting rights of a non-resident enterprise with a balance sheet total equivalent to EUR 3,000,000; (iii) submit a stock data report on cross-border equity investments if one or several economically affiliated non-resident enterprises hold 10% or more of the capital or voting rights in the resident company and the resident company has a balance sheet total of more than EUR 3,000,000 and (iv) submit a stock data report on total claims and liabilities vis-à-vis non-residents if the total claims or total liabilities at the end of a month exceed EUR 5,000,000. In particular the notifications under lit. (i) and lit. (iii) are frequently relevant in the context of a two-tier structure. In principle, all foreign trade reports are to be submitted electronically via the General Statistics Reporting Portal (*Allgemeines Meldeportal Statistik*) directly to German Central Bank (*Deutsche Bundesbank*).

VI. The ESOP at the HoldCo Level

1. EMPLOYEE PARTICIPATION PROGRAMS IN A CORPORATION

A big part of the job of a start-up CEO or founder is to put programs in place to incentivize employees and keep them satisfied with their jobs. Obviously, an employee stock option/stock incentive plan that grants equity incentives to certain (key) employees or a wider group (subject to continued employment vesting requirements as an employee-retention mechanism) is an important tool to keep the employees motivated and the interests aligned.



We have dedicated an entire edition of OLNS to explain (for German start-ups) the economics and incentive schemes behind employee participation programs and the main decisions founders have to make in order to design and implement a powerful incentive and retention tool[26]. We refer our readers to the explanations given there. In this Guide, we will focus on a few particularities for German start-ups with a US holding entity.

> Employee ownership is a consequence of the maturity of the ecosystem. As the market matures, employees get more sophisticated and are more willing to trade off salary for options.
>
> *Martin Mignot*, Partner at Index Ventures

In a typical German start-up, the company has two options: (i) Equity-based stock option plans (ESOPs) and (ii) virtual stock option plans (VSOPs). Whereas ESOPs give a beneficiary the right to buy stock at a specified exercise price (or "strike price"), VSOPs are designed to operate in a manner similar to an equity-based ESOP, but without delivery of actual shares or options. Rather, the beneficiaries obtain contractual claims (so-called "virtual shares" or "virtual options") against the issuing company for a cash payment in the case of a liquidity event if the liquidity event and other circumstances satisfy the terms of the plan. The amount of such claim is based on what a holder of a common share will get in the liquidity event (generally minus a base price or strike price, provided that here the strike price does not have to be paid but only serves as a deductible when calculating the beneficiary's claim against the company).

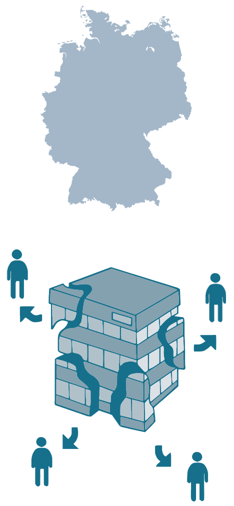
26. See OLNS#8 – the Guide can be downloaded here: https://media.orrick.com/Media%20Library/public/files/insights/2021/olns-8-esops-vsops-co.pdf

EMPLOYEE PARTICIPATION MODELS IN A TYPICAL GERMAN START-UP

Straight Equity & Equity-Based Options

- "Real" shares with (usually) voting and information rights as well as dividend payments.
- Notarization for grants of shares required if the start-up is a GmbH or UG. Note that the grant of "mere" options may (subject to certain exceptions) not require notarization.
- Risk of double liquid / dry and liquid / liquid taxation (except for hurdle or growth shares and sec. 19a shares – which can be tax advantageous).
- Such equity-based programs are still relatively rare, with the exception of hurdle or growth shares and sec. 19a shares for a small group of beneficiaries.

ESOPs



Virtual Share Option Programs

- "Virtual" shares:
  - No actual shareholder position; and
  - only entitlement to an economic participation in a future liquidity event (exit or IPO).
- No form requirements for grants to beneficiaries.
- One-time liquid / liquid taxation (high wage taxation).
- In German start-ups, such virtual programs are still the standard as they avoid the governance issues of the equity-based programs and scale better.

VSOPs

While virtual shares are (still) dominant in Germany, employee participation programs in the US are most often set up as equity-based. This is chiefly because of two main differences between both legal systems:

- In the US, it is possible to limit the shareholders' rights much more extensively. Unlike in Germany, US shareholders can be precluded from certain information rights as well as the possibility to challenge the shareholders' resolutions. In practice, whereas, in the US, an equity-based program does not make an exit transaction more complex (the beneficiaries have neither a contractual nor a *de facto* veto right), equity-based programs in Germany can in certain circumstances become a factor to consider when planning and structuring an exit process.
- Shares and options of a US entity can be transferred without special form requirements, whereas, in a German GmbH, a transfer of shares (and in certain cases even options) would be subject to notarization and will usually require the consent by the shareholders' meeting.

Before options under US ESOPs are issued to non-US tax residents, *e.g.*, employees of OpCo in Germany, it is advisable to consult experienced legal and tax counsel to ensure compliance with local law requirements and market practices.

However, in principle, the issuance of market standard US options to German tax residents should not cause material issues (note that allocations of restricted stocks may in certain cases result in dry income issues), while the issuance of virtual shares under a typical German market VSOP to a US tax resident will often require certain amendments to the German VSOP rules to ensure compliance with US tax rules (see below).

2. MAIN CONSIDERATIONS FOR ALLOCATIONS UNDER US ESOPS

2.1 Options and Restricted Stocks

Under a typical ESOP to be established at HoldCo, two types of awards get authorized, *i.e.*,

- options; and
- restricted stock.

Under US tax law, there are two types of stock options: (i) "Incentive stock options" or "**ISOs**" and (ii) "nonqualified stock options" or "**NSOs**." ISOs are stock options that are intended to qualify for the special tax treatment available under Section 422 of the US Internal Revenue Code. ISOs can only be granted to employees and are only relevant for beneficiaries taxable in the US (US residents but also US citizens living abroad) while non-US taxpayers will receive NSOs. The beneficiary will generally not recognize income as a result of the grant or exercise of ISOs (except potentially Alternative Minimum Tax upon exercise). However, any gain that the beneficiary realizes upon the sale or other disposition of shares purchased through the exercise of an ISO will be taxed at long term capital gain rates if the beneficiary sells the shares after certain holding periods. For ISOs the strike price must be equal to the fair market value which in term must be determined by a so-called 409a valuation while for NSO the board of directors of HoldCo can determine the strike price. However, due to certain tax issues related to the treatment of option awards in different jurisdiction, the company should seek advice by outside counsel before setting a strike price below the fair market value for NSOs (for German tax-residents, the strike price can be set at a lower value).

Restricted stock is a direct grant of actual ownership of the stock that vests upon grant. The stock can be "restricted" in several ways, notably vesting and repurchase options for the company as well as share transfers requiring the approval of the board of directors.

GERMAN TAX CONSEQUENCES FOR EMPLOYEES OF OPCO

Here is a brief overview of the most material tax consequences of awards under a HoldCo-ESOP to the employees of OpCo. We will limit ourselves to German tax law questions and only look at this from the employee's perspective and thus not discuss tax consequences for OpCo.

Point in Time/Event	Main Tax Consequences
At Grant of Options	No taxation (this applies as long as options are not transferred or otherwise commercially utilized).
At Grant of Restricted Stock	Unless purchased at fair market value, taxation on the spread between the fair market value of the purchased stock and the purchase price plus additional costs of purchase, if any (the time of taxation is postponed in individual cases if restricted stock is subject to such significant restrictions on disposal, profit distribution and other legal restrictions that, from a German perspective, the granting does not yet constitute an inflow. An inflow then occurs later when the restrictions cease to apply. If the market value has risen by then, the tax will also increase, so that the postponement of the time of taxation is generally disadvantageous). Tax rate: Up to approx. 47.5% (incl. solidarity surcharge, plus church tax, if any). Under the current law, the tax deferral per sec. 19a German Income Tax Act is not yet available for such share allocations as the allocation is not made by the employer (OpCo) but by a group company (HoldCo). For details and why this might change in the near future see further below.
At Vesting of Restricted Stock/Options	No taxation (this applies as long as options are not transferred or otherwise commercially utilized).
At Option Exercise	Taxation of the spread between the fair market value of the shares issued upon the exercise of the options at the date of exercise and the exercise price plus costs of exercise, if any (see above on the possible postponement of the time of inflow and taxation in individual cases with significant restrictions). Tax rate: Up to approx. 47.5% (incl. solidarity surcharge, plus church tax, if any).
At a Subsequent Sale of Restricted Stock/Shares Issued Upon Exercise of Options	Capital gains taxation on the spread between the disposal proceeds and the interim fair market value of the issued shares which has been the tax basis for income tax purposes at option exercise (or in individual cases at the postponed inflow date) plus costs of disposal, if any. Tax rate: **1.** Employee has not had ownership interest of 1% or more at any time in the last 5 years: Up to approx. 26.4% (incl. solidarity surcharge, plus church tax, if any). **2.** In other cases: Up to approx. 28.5% (incl. solidarity surcharge, plus church tax, if any). According to the latest rulings of the highest German tax court, residual uncertainties regarding the applicability of capital gains taxation finally appear to have been clarified in favor of the employee if he or she receives a market standard price for the sale; however, the tax authorities have yet to react.

2.2 Some US ESOP Terms

While we discussed the main terms relevant for any kind of employee participation programs in another Guide, we will limit ourselves here to some more material differences between typical terms of a German (VSOP) and a US (ESOP) program.

Suspended Vesting: In German market programs, it is common to suspend vesting for periods of absence only with certain exceptions, *e.g.*, there is usually no suspension during maternity leave or paternity leaves up to a certain period of time etc. Such non-suspensions (or vesting credits upon return) are less common in the US, but can be agreed.

Accelerated Vesting: An accelerated vesting provision is rather unusual for participants below C-level and if agreed, the double-trigger acceleration is usually agreed.

Leaver Provisions: US programs usually do not distinguish between good and bad leaver. Rather, only if a beneficiary is terminated for cause (such term is usually very narrowly defined and includes severe cases of intent, criminal actions and severe cases of non-compliance), he or she will lose all options (be they vested or unvested).

Exercise Periods: This is in our opinion a common source of confusion and sometimes frustration. Under a typical German VSOP, a beneficiary who leaves the company does usually not have to do anything. Absent a case of a bad leaver, he or she will usually keep their claims from the vested virtual shares for a cash payment by the company in case of a future liquidity event (though the plan may foresee a term upon which all vested virtual shares will just expire without compensation).

The situation under a US ESOP is usually very different. Here, an option must be exercised (to the extent that the option was vested and previously unexercised) within certain periods of time following a termination of service of the respective beneficiary: Typical exercise periods are:

- generally: three months;
- in case of a termination due to disability: twelve months; and
- termination due to death: twelve months.

(Restricted stocks on the other hand do not need to be exercised – for restricted stock, the payment by the beneficiary is made upon purchase and not upon exercise like with the options.)

An exercise period means that beneficiaries who became a leaver must generally exercise any vested options within the stipulated timeframe or risk forfeiture of all vested but unexercised options. Depending on the amount of the strike price agreed in the option agreement this is sometimes considered unfair and a hiring disadvantage by European companies since the beneficiary is in this scenario forced to either exercise the option and pay taxes on any positive delta between the exercise price and the fair market value of the shares underlying the option at the point of time the option is exercised or to lose his or her options. Therefore, some companies agree to extending the post termination exercise period up to the date the option as such expires (usually ten years after the date of its grant).

Note that while longer exercise periods are possible in the respective individual option agreement (in particular, German beneficiaries might request this because they are not used to having to pay a cash strike price at a point where they do not know if a liquidity event is likely or not), in any case, ISOs must in fact be exercised within three months to retain ISO status (relevant only for US tax residents).

3. US ESOP ALLOCATIONS AND SEC. 19A GERMAN INCOME TAX ACT – MAYBE ONE DAY

For those of our readers who are more in the "espresso camp" (quick shot), you can skip this Chapter for now as the recently enacted tax deferral rules under sec. 19a German Income Tax Act (*Einkommenssteuergesetz* – "**EStG**") are not (yet) available for allocations to employees of OpCo under the ESOP established at HoldCo level. The current law requires that the allocated shares (directly or by exercising a previously granted option) must be shares of the employer and that will often not be HoldCo but OpCo. However, if you (like the authors responsible for this Chapter) enjoy a good cappuccino and have a minute, it might be a good idea to keep reading. Most recently, there were rumors that the scope of the tax deferral rules might be broadened to also include allocations by a group holding entity (such as HoldCo) to employees of its subsidiaries (such as OpCo) – this is called the "group privilege." This could also benefit foreign group holding entities in the future. However, there is still a long way to go before the law is passed.

One of the main obstacles with the granting of real shares to employees (other than the persistent governance issues) is the so-called dry-income taxation. In a nutshell, if employees are granted real shares below their fair value, under German tax law, this would trigger wage taxes (uuuh…) on the fair value of such shares (whatever that is…) usually right upon grant (ouch…). The beneficiary would be taxed at a time when he or she gets no liquidity.

For years, these shortcomings have been criticized by multiple players in the ecosystem. Politicians heard the calls (though one may wonder if they actually listened) and in 2021 passed the *Fondsstandortgesetz*. As a result, the tax-free allowance for employee shareholdings (sec. 3 No. 39 EStG) had been increased for the first time since 2009 (!) and quadrupled from EUR 360 to EUR 1,440 with effect from 1 July 2021 (wow, what a leap forward…). More importantly, however, sec. 19a EStG in the version of the *Fondsstandortgesetz* provided for the first time for a deferral of wage/income tax on the spread between the issuance price, if any, and the fair value of the shares upon issuance for up to 12 years under certain conditions. However, that legislative reform had major flaws as it made the deferral, amongst others, subject to continued employment of the beneficiary which placed a huge tax risk on beneficiaries who considered leaving their employer prior to an exit. In addition, the law also applied only for certain SME and excluded many of the later-stage German growth companies. It quickly became apparent that the *Fondsstandortgesetz* had not solved many of the real problem(s).

So, the German legislator moved quickly to reform the prior reform bill. As of 1 January 2024, sec. 19a EStG in the version of the *Zukunftsfinanzierungsgesetz* was enacted, which brought important changes (even if the group privilege initially envisaged did not make it into the final text of the law):

The new German tax framework for employee participations in start-up and growth companies has been received warmly. From our humble perspective, it is actually now in a better shape although a few potentially prohibitive issues have still not been solved (and the governance issues will largely persist, *e.g.*, the GmbH does not cope well with too many people on the cap table and the continued need to involve the notaries makes the implementation expensive…).

Here are some of the new rules:

- The general tax exemption for the pecuniary advantage of providing employee participation free of charge or at a discount should become more attractive (cf. sec. 3 no. 39 EStG): Increase in the yearly tax allowance, to be granted under certain conditions, from EUR 1,440 to EUR 2,000.
- The regulations regarding the tax deferral in the case of employee participation are to be simplified in order to avoid taxation of the respective employee without an inflow of liquidity (dry income) (cf. sec. 19a EStG):
- More start-ups can make use of the new rules compared to the prior rules under the *Fondsstandortgesetz*:
  - <1000 vs. <250 employees; ≤EUR 100 million vs. ≤EUR 50 million annual turnover; ≤ EUR 86 million vs. ≤EUR 43 million balance sum;
  - threshold must have been met once in the current or the preceding six years vs. in the current or last year; and
  - the start-up must not be older than 20 years vs. 12 years.
- Extension to cases in which the company shares are not owned by the employer himself but granted by the shareholders.
- Treatment of leaver events: Limitation of income to consideration paid by the employer for re-acquisition of employee's shares (vs. previous floor being the fair market value), also, taxation only occurs at later share transfer or sale if employer assumes secondary liability (deferral not available previously).
- In addition, the maximum term for the deferred tax liability was increased to 15 years (was 12 years), which can now, under certain circumstances, be further extended by the employer assuming liability.

4. EXCURSUS: GRANTING GERMAN VIRTUAL SHARES TO US TAXPAYERS

German start-ups frequently seek to hire talent irrespective of location or pursue an internationalization strategy that requires them to hire people on the ground. Often, these international hires will expect some form of employee participation. So, the question arises whether the German start-up can use its German VSOP also for such international hires.

While the answer is "generally, yes" from a practical perspective, German start-ups should pay particular attention when using a typical German market VSOP to grant virtual shares to employees who are tax resident in certain jurisdictions, notably the US. Using a VSOP in the US is doable but usually requires attention to the following two matters:

US Tax Issues: We will save you the opaque details of US tax rules here, but suffice it to say that the issuance of virtual shares under a VSOP to US beneficiaries may result in adverse tax consequences or result in a taxable event upon meeting any time-based vesting requirement (!) unless there is an additional real risk of forfeiture for the beneficiary. Why is this problematic? Well, VSOPs usually do not provide for an expiration date for the virtual shares granted thereunder (or they foresee a very long term of 10+ years). If the VSOP includes in its definition of exit/liquidity event also an IPO or other public listing (as it is commonly the case), then in order to comply with US tax rules, it is mandatory that the plan foresees a time limitation for the virtual shares that constitutes an additional risk of forfeiture. The US market standard would be seven years after the grant. This means, that the VSOP must foresee – at least for its US participants – that the virtual shares will expire without any compensation if no exit/liquidity event will occur within such period of usually seven years after the grant of the respective virtual shares.

A potential alternative would be to take the IPO out of the list of trigger events for the VSOP (though for obvious reasons the beneficiaries will not like that approach though there are potential economic substitutes available, *e.g.*, IPO bonus arrangements, but it can be difficult to structure those arrangements under US tax rules).

Against this background, German start-ups should obtain proper legal and tax advice from counsel with experience on both sides of the pond before issuing virtual shares to a US tax resident or risk getting in trouble with the IRS or inadvertently triggering adverse tax consequences for the employees.

US Securities Rules: The other aspect that should be checked before issuing virtual shares to US beneficiaries is whether such issuance would comply with US securities laws. Virtual shares can qualify as "securities" within the meaning of US law, both on a federal and state level. The good news is that often relatively broad exemptions from registration requirements will be available for the underlying programs (though certain disclosure requirements might kick in once certain thresholds are exceeded) but that also depends on the state in which the respective US beneficiary resides. In addition, in some states such as New York, filing rules may apply though they should not be particularly burdensome to comply with.

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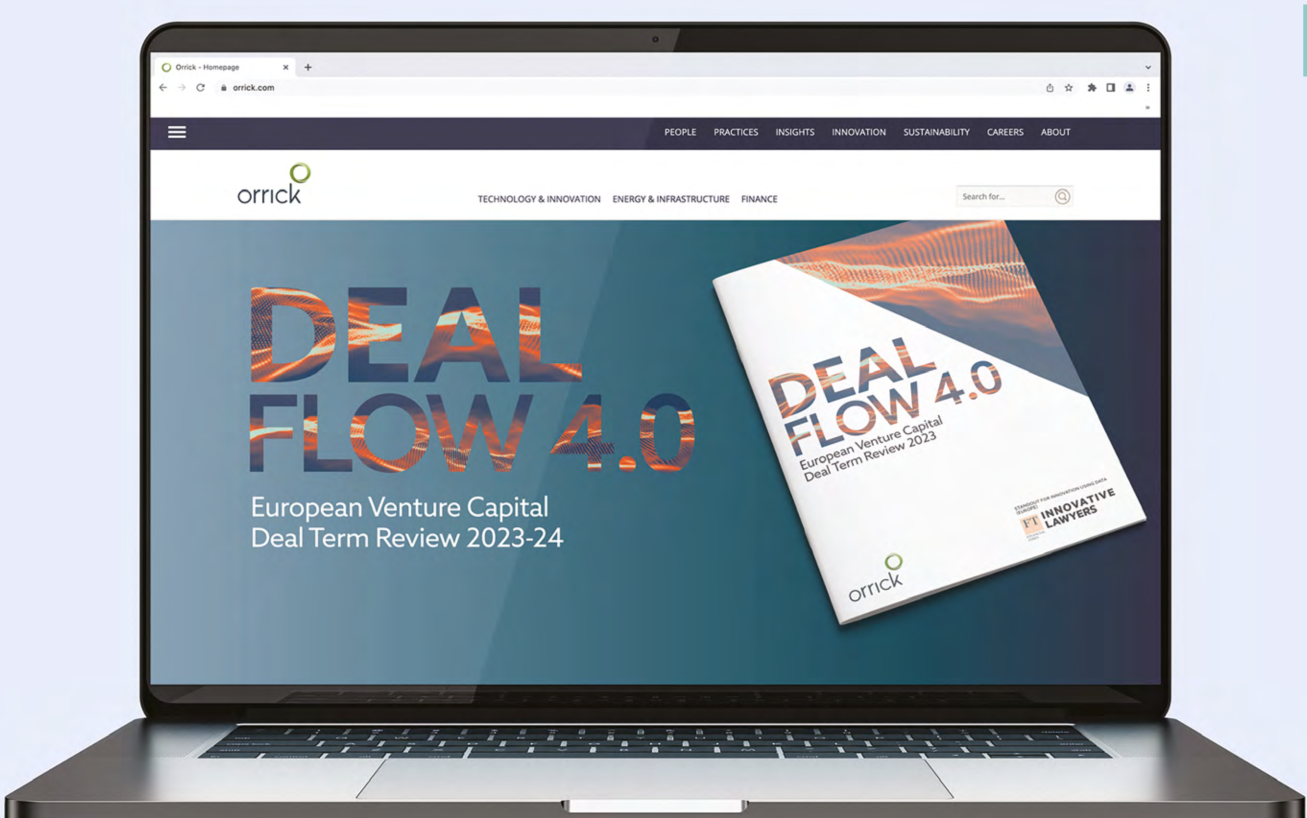

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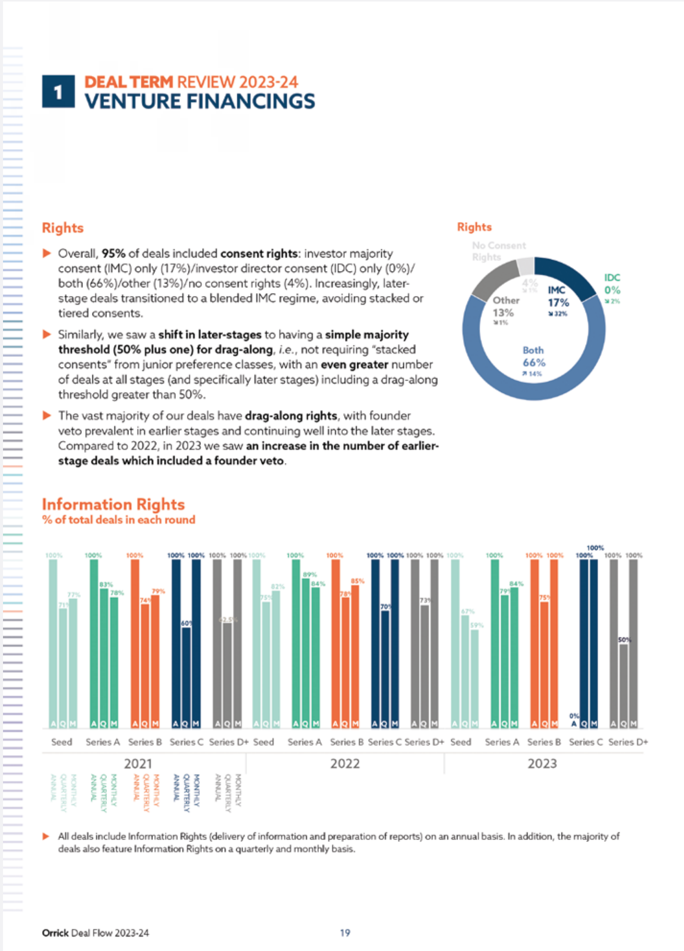
1 DEAL TERM REVIEW 2023-24
VENTURE FINANCINGS

Rights

- Overall, **95%** of deals included **consent rights**: investor majority consent (IMC) only (17%)/investor director consent (IDC) only (0%)/ both (66%)/other (13%)/no consent rights (4%). Increasingly, later-stage deals transitioned to a blended IMC regime, avoiding stacked or tiered consents.
- Similarly, we saw a **shift in later-stages** to having a **simple majority threshold (50% plus one) for drag-along**, *i.e.*, not requiring "stacked consents" from junior preference classes, with an **even greater** number of deals at all stages (and specifically later stages) including a drag-along threshold greater than 50%.
- The vast majority of our deals have **drag-along rights**, with founder veto prevalent in earlier stages and continuing well into the later stages. Compared to 2022, in 2023 we saw **an increase in the number of earlier-stage deals which included a founder veto**.

Information Rights
% of total deals in each round

- All deals include Information Rights (delivery of information and preparation of reports) on an annual basis. In addition, the majority of deals also feature Information Rights on a quarterly and monthly basis.

Orrick Deal Flow 2023-24 19

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Other Issues in this Series

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OLNS #5 — Venture Financings in the Wake of the Black Swan
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In the current environment, all market participants, and especially entrepreneurs, need to be prepared for a softening in venture financing and make plans to weather the storm. In this guide, we share some of our observations on the most recent developments and give practical guidance for fundraising in (historically) uncertain times. We will first provide a brief overview of the current fundraising environment, and then highlight likely changes in deal terms and structural elements of financings that both entrepreneurs and (existing) investors will have to get their heads around.

OLNS #6 — Leading Tech Companies Through a Downturn
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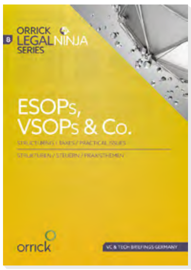
Steering a young technology company through a downturn market is a challenging task but if done effectively, the start-up can be well positioned to benefit once the markets come back. While OLNS#5 focused on raising venture financing during a downturn, in this guide, we want to give a comprehensive overview of the legal aspects of some of the most relevant operational matters that founders may now need to deal with, including monitoring obligations and corresponding liabilities of both managing directors and the advisory board, workforce cost reduction measures, IP/IT and data privacy challenges in a remote working environment, effective contract management and loan restructuring.



OLNS #8 — ESOPs, VSOPs & Co.: Structuring / Taxes / Practical Issues

June 2021

OLNS#8 provides a comprehensive overview of equity-based and Employee-ownership programs (or in short "ESOPs") play a critical role in attracting and retaining top talent to fledgling young companies. Stock options reward employees for taking the risk of joining a young, unproven business. This risk is offset by the opportunity to participate in the future success of the company. Stock options are one of the main levers that start-ups use to recruit the talent they need; these companies simply can't afford to pay the higher wages of more established businesses. With OLNS#8, we want to help start-ups and investors alike to better understand what employee ownership is, structure them in a way that is congruent with incentives, and implement them cleanly.

OLNS #9 — Venture Capital Deals in Germany: Pitfalls, Key Terms and Success Factors Founders Need to Know

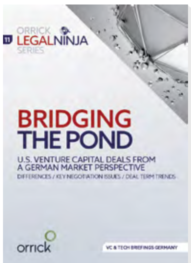
October 2021

Founding and scaling a tech company is a daunting challenge. OLNS#9 summarizes our learnings from working with countless start-ups and scale-ups around the world. We will give hands-on practical advice on how to set up a company, how (not) to compose your cap table, founder team dynamics and equity splits, available financing options, funding process, most important deal terms and much more.

OLNS #10 — University Entrepreneurship & Spin-offs in Germany – Set-up / IP / Financing and Much More

November 2022

German universities are increasingly becoming entrepreneurial hotbeds, but university spin-offs face some unique challenges, some of which could – with the right support systems and policies in place – be considerably less stressful. OLNS#10 helps founders by providing them with an overview of how to get a university-based start-up off the ground. We will discuss founder team composition and equity-splits, the composition of the first cap table, important considerations for the initial legal set-up (founder HoldCos and US holding structures) as well as financing considerations. We will also return again and again to the specifics of IP-based spin-offs, especially when it comes to how a start-up can access the university's IP in an efficient manner.



OLNS#11: Bridging the Pond – US Venture Capital Deals from a German Market Perspective

August 2023

Venture financings and deal terms in the US and in Germany have many similarities but there are also some differences. To help navigate these challenges, we have put together OLNS#11. OLNS#11 is a guide that offers founders and investors with a "German market" background an introduction to US VC deals and helps them understand where US deals differ from a typical German financing. OLNS#11 also augments and builds on OLNS#7 that explains how German founder teams can get into a US/German holding structure (the famous flip).

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