START-UP / VENTURE CAPITAL

Dear Reader,

An exciting year is nearing its end. For the Start-up / Venture Capital division at BEITEN BURKHARDT, it is already clear that a review of 2018 will reveal record numbers of invest-ment rounds. We thank you for your trust and appreciate your loyalty!

We have been very interested to see the rapid developments in corporate venturing. Many medium-sized companies now view their own venture arm or start-up promotion programme as a standard tool in their modern corporate strategy, particularly in connection with digitalisation. It therefore comes as no surprise that our corporate venturing events, such as those we held in Frankfurt and Munich, have been particularly well received. We will definitely take this into account when designing our 2019 Workshop Programme; *we will keep you posted*.

A positive development in the local market is the advance of standardised VC investment documentation in Germany: the German Standards Setting Institute was established in the middle of this year by the Business Angels Netzwerk Deutschland e.V. (Association of Business Angels and their Networks in Germany) and the Bundesverband Deutsche Startups e.V. (German Startups Association) and aims to compile a set of standardised contractual documents for start-up financing in Germany. Work commenced with the standard documents for a convertible loan; a term sheet and other documents will follow. Such standardised documents have long been part of daily VC life in the USA, venture capital country No. 1, and are a necessary step to bring start-ups and investors together in an uncomplicated way, especially in the first financing rounds. At European level, there have also been discussions at expert conferences and moves to compare the clauses used in investment rounds in various countries and, where possible, to align them. We will use this forum to keep you up-to-date with these developments.

We are pleased to be able to present the following articles in this edition of our Newsletter:

- **Dr Gesine von der Groeben** looks at a hot topic for many start-ups, founded in the legal form of Ltd.: the necessary return to continental Europe before Brexit
- **Christian Hess**, reports on blockchains, in particular, on how innovations in the area of blockchains should and can be protected
- **Christian Döpke** and Dr Mathias Zimmer-Goertz explain the responsibilities of the administrator of a Facebook fan page under data protection law
- **Dr Axel von Walter** and **Paul Wilde** provide an update on the developments in data protection under the GDPR since May 2018
- **Tassilo Klesen** summarises the common issue of what should be covered by the shareholders' agreement in an investment round and what is better anchored in the articles of association of a start-up
- **Moritz Bocks** deals with the topic of investment valuation, which is often underestimated by corporates
- In keeping with the season, **Dr Michaela Felisiak** and **Dr Erik Schmid** conclude by looking at the problem of employees who choose to work, despite having a doctor's certificate.

Happy reading!

Best regards
The BEITEN BURKHARDT Start-up / Venture Capital Team

BEITEN BURKHARDT

Brexit – And a proposal designed to help German companies return to Germany

Brexit has not only hit many banks hard a not insignificant number of small companies that chose the legal form of a UK limited company but have their head offices in Germany are increasingly considering returning to Germany. Once Brexit becomes effective, these companies will no longer be recognised in Germany, as they will lose their freedom of establishment. Now, a proposal by the Federal Ministry of Justice seeks to produce relief.

CURRENT SITUATION

An estimated 8,000 to 10,000 small and medium-sized companies mostly start-ups with few capital resources – chose, when setting up their companies, the legal form of a "private company limited by shares", in short, limited company (Ltd). Their head offices, however, are in Germany.

Once Brexit becomes effective whether hard or soft these companies will no longer be able to benefit from the freedom of establishment applicable in the EU, and will thereby lose their legal personality in Germany. According to decisions by the German Federal Court, they will instead be treated as one of the corresponding legal forms available in Germany, i.e. either as general partnership (*Offene Handelsgesellschaft - OHG*), or as partnership under the German Civil Code (*Bürgerliches Gesetzbuch - BGB*) or non-trading partnership (*Gesellschaft bürgerlichen Rechts - GbR*), depending on whether they engage in trade or not. If the company only has one shareholder as is often the case in small companies and start-ups the shareholder would even be considered a sole trader (*Einzelkaufmann*) or simply an individual (*Einzelperson*) after Brexit. The same will happen to public limited companies, in short PLCs.

RISK OF UNLIMITED PERSONAL LIABILITY

In all of the above cases, the company or the shareholders of the company would be subject to a personal and unlimited liability with their personal assets for all company liabilities, even for existing liabilities. It is, however, exactly this scenario that founders sought to avoid in most cases when establishing a company limited by shares. So what can be done?

MOVING GENERALLY POSSIBLE

In order to "move" such a company to Germany, a German legal entity will be needed in any case once Great Britain has left the European Union. As of today, companies that plan to return to Germany practically only have the following two options:

1. Sale of all assets and contracts of the limited company to a newly founded German company (*e.g. a company with limited liability, Gesellschaft mit beschränkter Haftung - GmbH)*, and subsequent liquidation of the limited company. This approach is, however, somewhat complicated because a transfer of contracts (*customers, suppliers, developers, employees etc.*) generally generally require the consent of the contractual partners. A transfer may also reveal hidden reserves, which can result in tax disadvantages.
2. Cross-border transformation of the limited company into a German GmbH: first, a German GmbH is established by way of the so-called *Sachgründung* (*formation by non-cash capital contribution*), using all of the shares in the limited company as the contribution. The limited company is then merged with the GmbH, following the regulations of the German Act Regulating the Transformation of Companies (*Umwandlungsgesetz, UmwG)*. This approach, however, includes many formalities and is labour-intensive and costly, which small companies in particular might not be able to shoulder.

Further models have been discussed in legal literature, presenting approaches to "move" a limited company to Germany. All of these models, however, suffer either from the uncertainty as to whether such a solution is at all practicable, owing to the absence of a statutory basis, or the significant formal and financial efforts involved.

COST-EFFICIENT SOLUTION: TRANSFORMATION INTO PARTNERSHIP?

A proposal by the Federal Ministry of Justice of 3 September/ 10 October 2018 proposes a less costly solution: it contains plans to add regulations on merging companies limited by shares with partnerships to sections 122a et seq. of the *Umwandlungsgesetz*. Previously, this option of a cross-border merger was only open to companies limited by shares. To "move" has therefore always required the establishment of a German company limited by shares in the form of a GmbH by way of a *Sachgründung*. The "Mini-GmbH" an enterprise company (with limited liability) (*Unternehmergesellschaft*), in short UG was not an option, as a *Sachgründung* is prohibited for this type of company.

The proposed additions to sections 122 et seq. UmwG, still requires the formation of a German legal entity, just as before. However, companies affected by Brexit will now be allowed to transfer, for instance, into a limited partnership (*Kommanditgesellschaft - KG*). Depending on capital resources, either a GmbH or a UG could have an interest as a personally liable partner. Either a GmbH & Co. KG or a UG & Co. KG would then be established. In the latter case, the share capital may be below EUR 25,000.00 since the statutorily minimum share capital is EUR 1.00. This would make the capital that the German legal entity would have to summon up for formation very small, while at the same time it would protect shareholders from unlimited personal liability.

The planned new regulation thus creates an additional option for concerned companies to transform, complementing the existing possibilities. It is doubtful that this option really carries less effort and costs though. It remains necessary to form a German company, which will merge with the British limited, thus incurring costs for legal advice and a notary. In the case of a GmbH & Co. KG or a UG & Co. KG, even two shareholders' agreements would have to be prepared and one would require notarisation. Also administrative expenses would grow, since it would be necessary to prepare two sets of financial statements in the future. Finally, the company would have to undergo the entire merging process, which requires the involvement of the relevant British authorities, again resulting in consulting and translation fees.

Still, the initiative should certainly be welcomed, as every new alternative offers affected companies more flexibility to find, the best way to bring their company to Germany, depending on their individual situation, while avoiding excessive personal liability risks and taking the relevant costbenefit considerations into account.

Dr Gesine von der Groeben
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Frankfurt am Main

This article has been published in a different version for the first time in: DER PLATOW Brief, PLATOW Recht, edition from 17 October 2018.

IP / IT: Protecting blockchain innovations with patents or as a trade secret – an overview of the advantages and disadvantages

Despite significant losses in the market value of nearly all cryptocurrencies in 2018, interest in the underlying blockchain technology remains unbroken. This article focuses on the question of whether it is best to protect blockchain innovations with patents or as a trade secret.

A blockchain is a decentralised peer-to-peer (P2P) database, in which data, such as for example about transactions, is saved in data blocks that are linked using cryptography and in time. This linking makes blockchain secure. Each block contains a time stamp, data and a cryptographic hash of the previous block.

PROTECTION BY PATENTS

Patents are granted for any inventions in all areas of technology, provided that they are new, involve an inventive step and are industrially applicable (see Art. 52 para. 1 European Patent Convention (EPC) / § 1 German Patent Act (*Patentgesetz, PatG*)). The maximum term of protection for a patent is 20 years from the date of filing of the application (Art. 63 EPC / § 16 PatG). These principles also apply to patents on blockchain innovations. The European Patent Office considers that patents may be granted for blockchain innovations provided the innovations are related to cryptography, computers or networks, produce a technical effect and fulfil the further requirements outlined above. An effective patent gives the holder an exclusive monopoly right over the patented invention. It allows the holder to prevent third parties from using the invention.

Patents for blockchain innovations are becoming increasingly popular and patent applications are currently experiencing a real boom. While only a few hundred patents have been granted in relation to blockchain technology, thousands of applications have been filed. Applications have come from start-ups and established technology corporations, such as IBM, GE, Sony, HP, Accenture and SAP. Chinese companies are particularly strongly represented, led by Alibaba with currently nearly 50 filed patent applications.

It is still too early to say whether patents will actually be granted for the majority of these patent applications and whether the patents will be maintained if their validity is challenged. However, the ability to enforce a patent against competitors is an indication of its value for the patent holder. Still, the high number of patent applications suggests that there could be “patent wars” in the area of blockchain technology in the future, similar to those seen in the telecommunications industry.

For this reason alone, building a patent portfolio can be a strategic consideration for companies active in the area of blockchain technology.

PROTECTION AS A TRADE SECRET / KNOW-HOW PROTECTION

Building a patent portfolio is expensive and can be a real challenge, especially for young start-ups. In addition, many years can pass between the filing of an application for a patent and the grant of that patent. In the worst case – particularly in the case of fast paced innovation – the technology can be outdated before the patent is granted.

This downside to the patent system has made some blockchain innovators, especially start-ups, decide instead to protect their blockchain innovations as a trade secret or secret know-how.

Fewer conditions apply to the protection of trade secrets. However, contrary to a patent, a trade secret is not a comprehensive quasi-property right.

Known as the European Trade Secrets Directive, Directive (EU) 2016/943 has significantly increased the level of protection for trade secrets. Germany is expected to implement the Directive by the end of this year. According to the Directive, a trade secret will exist when three conditions are fulfilled:

- First, the information in question must be secret, i.e. it is not generally known by persons within circles that normally deal with this kind of information, nor is the information readily accessible.
- Second, the information must have a commercial value because it is secret.
- Third, the information holder must have taken steps that were appropriate in the circumstances to protect this information.

If these conditions are fulfilled, the holder of the trade secret will be entitled to injunctive relief and damages against third parties, who seek to unlawfully exploit the trade secret. How the courts will in particular apply the third condition set out above will only be clear once the first court judgments on violations of trade secrets under the new law have been handed down.

One disadvantage of trade secrets is that they provide holders with no protection against parallel developments or lawful reverse engineering by competitors, as such measures are legal.

SUMMARY
Patents and trade secrets both offer advantages and disadvantages for the protection of blockchain innovations. It is therefore important, especially for start-ups, to consider an appropriate strategy at an early stage. Any considerations must take into account the high costs of strategic patent portfolios and the high speed of innovation in this area of technology. On the other hand, a patent portfolio can present a competitive advantage: not only can IP rights be leverage against third party claims, but they can also significantly increase the value of the company.

Christian Hess
Lawyer | LL.M. | Certified Specialist for IP law
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Data Protection Law: Update: Responsibility of the administrator of a Facebook fan page under data protection law

On 5 June 2018, the European Court of Justice (ECJ) decided that the creation of a Facebook fan page established responsibility on the part of the fan page administrator (Case No. C-210/16, *Unabhängiges Landeszentrum für Datenschutz Schleswig-Holstein v Wirtschaftsakademie Schleswig-Holdstein GmbH*). Accordingly, Facebook and the fan page administrator are jointly responsible for compliance and must therefore conclude an agreement to determine the division of responsibilities in accordance with Art. 26 of the General Data Protection Regulation (GDPR).

In addition, the persons considered and the data protection agencies are not limited to make claims on the basis of data protection regulations against Facebook only, but can also directly make claims against the respective fan page administrator. There is a risk that against the fan page administrator warnings, prohibition orders and fines may be invoked.

These legal risks increased on 5 September 2018 with the adoption of the resolution by the Germa Data Protection Conference (DPC – DSK), the Committee of Independent Federal and Laender Data Protection Authorities. The full text of the resolution (only available in German) can be found here.

The most important questions arising in relation to the resolution are answered below:

WHAT DOES THE DPC RESOLUTION COVER?

First, the DPC noted that Facebook has not changed its general practice, despite the judgment of the ECJ: it still used cookies with identifiers, even for people who didn't have a Facebook account, when these people went beyond the homepage of the fan page and retrieved content. In addition, fan page visits were still being evaluated according to specific, sometimes predefined criteria as part of the "insights" function and these evaluations were still being made available to website operators.

The DPC further criticised the fact that Facebook had not yet established an agreement with fan page administrators on joint responsibility for data processing.

Administrators were also taken to task. The DPC emphasised that it is illegal to set up a fan page, such as using Facebook, without an appropriate agreement on the division of responsibilities in place. Both parties (Facebook and the fan page administrator) needed to provide greater clarity on this situation and make the necessary information available to visitors to the fan page as data subjects. The DPC again pointed out that data subjects could assert their rights under the GDPR (e.g. right to information) against the administrator of the fan page, too.

In this respect, the DPC established a list of questions that both Facebook and the fan page administrator had to be able to answer. These covered, for example, how the responsibilities were shared between the administrator and Facebook, the purpose and legal basis of the processing of personal data, how the key aspects of the agreement about their shared responsibility would be made available and how the protection of the rights of data subjects would be ensured.

HOW DID FACEBOOK REACT?

In reaction to the DPC resolution, Facebook supplemented their general terms and conditions on the use of "Insights" with a "Page Insights Controller Addendum".

In this Addendum, Facebook repeats the assessment of the ECJ and explains that, although the fan page administrator is jointly responsible, together with Facebook Ireland Ltd, for the processing of insights data, Facebook takes primary responsibility for the processing of this data and for compliance with all applicable obligations under the GDPR.

Facebook then confers upon the controller of the fan page the obligations to ensure that they have the legal basis for the proces-

sing of Insights, to identify the data controller of the page and to otherwise comply with all applicable legal obligations. In addition, administrators must comply with their reporting obligations (for more information see below).

To the extent that the fan page is used or accessed for business or commercial purposes, all legal actions in connection with Insights are to be subject to the laws of Ireland and fall under the jurisdiction of the Irish courts.

The full Addendum can be found here.

WHAT MUST BE IN AN AGREEMENT ABOUT JOINT RESPONSIBILITY?

According to Art. 26 of the GDPR, the two controllers, who are jointly responsible for the processing, must determine, in a transparent manner, their respective responsibilities for compliance with the obligations under data protection law. This relates, in particular, to the exercise of rights by data subjects and the duty to provide information.

SHOULD I SHUT DOWN MY FACEBOOK FAN PAGE?

It is still not necessary to immediately shut down any Facebook fan pages. However, it should be kept in mind that it is practically impossible to ensure that the operation of a fan page will be 100 percent legal at the moment. At the same time, implementing certain measures can reduce the risk that consumer protection organisations or supervisory authorities will become involved.

It remains to be seen whether or not the German Federal Court of Justice (*Bundesgerichtshof - BGH*) will find that the processing of personal data as part of the general use of Facebook constitutes a breach of data protection law. If this is the case, further action will be required, especially from Facebook.

WHAT ACTIONS SHOULD FAN PAGE ADMINISTRATORS TAKE?

DESIGNATE A RESPONSIBLE BODY / DATA PROTECTION OFFICER

The fan page controller must name the body that is responsible for the processing. This will normally be the controller itself, so that its name and contact details (postal address, email and/or telephone number) must be provided. To the extent that the controller has also appointed a data protection officer, the contact details of this officer should also be provided.

DESIGNATE THE LEGAL BASIS

Moreover, the fan page administrator must specify the legal basis for the processing of Insights data. Two possible approaches can be considered.

The controller could rely on a legitimate interest (Art. 6 para. 1 f) GDPR), because Insights provide an understanding of the visitor structure, which enables administrators to adjust website content in order to make it more relevant and increase user satisfaction. This in turn can increase the reach of the fan page and the number of users, which can yield economic or other perceived benefits for the fan page controller. With numerous discussions and articles in the media, it can reasonably be assumed that users expect their data to be used for the purposes of analysis every time they use Facebook.

Supervisory authorities, however, have taken a narrower view; they consider that such tracking measures require the consent of the data subject.

At present, it is not technically possible for an administrator of a Facebook fan page to gain this consent, as the administrator does not have the possibility of explaining the internal processing activities of Facebook to the user before that processing begins.

Neither approach can therefore guarantee legal security for the operation of a fan page. In light of the fact that it is de facto impossible for the administrator to obtain the informed consent of the user, it seems advisable to instead use Art. 6 para. 1 f GDPR as the legal basis for processing. As an administrator of a fan page can use Insights for economic and other perceived benefits and users assume that their data will be processed, this appears, for the time being, to be a sensible approach. In the case of dispute, a court would have to clarify whether the strict interpretation of the supervisory authorities applies at all.

For those fan page administrators, who would rather not accept the remaining risk that measures might be imposed by the supervisory authority, the only other alterative at the moment is to (temporarily) deactivate the fan page.

NOTIFICATION / FORWARDING

If a data subject or a supervisory authority contacts the fan page administrator about the processing of Insights data and the obligations assumed by Facebook, Facebook requires the administrator to forward this request and all information to Facebook within seven days. Facebook has made a specific form available for this purpose.

OTHER INFORMATION OBLIGATIONS

Facebook makes the “Page Insights Controller Addendum” available to data subjects. In light of the fact that this Addendum must also be easily accessible to non-Facebook users, it is recommended that the fan page controller also provide a link to the Addendum on their fan page. Where available, the fan page should also contain a link to the privacy statement or integrate it into the “our story” section of the fan page.

SUMMARY

As Facebook has not fully answered the questions of the DPC, it is not yet clear, how the data protection authorities will proceed. At least with respect to the transparent determination of the respective responsibilities of Facebook and fan page administrators as joint controllers, the “Page Insights Controller Addendum” seems to fulfil the requirements.

Fan page administrators are still faced with the risk of determining a valid basis for the processing of Insights.

Commercial fan page controllers should also bear in mind that Facebook wants to move all legal disputes that arise in relation to Insights to Ireland.

We therefore recommend that controllers implement the measures outlined above, in order to minimise their risks under data protection law.

Christian Frederik Döpke
Lawyer | LL.M.
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Dusseldorf

Mathias Zimmer-Goertz
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Dusseldorf

Data protection since May 2018: The GDPR for Start-ups

On 25 May 2018, a new epoch began for data protection in Europe: the General Data Protection Regulation (Regulation EU 2016/679 – GDPR) now forms the European framework for data protection. Even if numerous national and European provisions continue to apply to the protection of personal data, the GDPR places demanding requirements on corporate structures and on the processing of personal data. With this in mind, start-ups should not only take the general GDPR considerations into account, but should ask themselves some additional questions.

WHAT'S NEW?

The GDPR builds upon the approach taken by the previous data protection law and modernises this approach based on the experience gathered over the last 20 years, as well as the relevant case law. The GDPR contains a number of new elements that are designed, on the one hand, to strengthen the protection of the rights of data subjects and, on the other hand, to facilitate the transfer of data within the digital internal market for companies. The GDPR introduces the basic principles of data protection through technology and default privacy settings ("privacy by design" and "privacy by default") in order to ensure that data protection interests are taken into account in business process and products from the very start. New transparency requirements strengthen the rights of data subjects and give them more control over their personal data. A new element in this regard is the right to data portability, which allows a data subject to demand that a company transfer any personal data, which the data subject made available the company based on consent or a contract, to or back to another company. The regulation also gives data protection authorities the power to impose fines on data controllers and processors of up to EUR 20 million or four percent of the worldwide annual group turnover. In addition, data subjects may claim compensation for non-material damage caused as a result of serious violations of the data protection provisions. Previously, companies were obliged to notify and ensure that prior checks were performed on processing operations that were likely to present specific risks. These requirements have been abolished. In their place is an instrument that is unfamiliar to German companies, and requires the evaluation of the risks before starting data processing: the data protection impact assessment.

WHAT IS KEY: THE COMPANY IS RESPONSIBLE

One of the key principles that the GDPR seeks to establish is the responsibility of companies to ensure effective data protection. While a company wishing to process personal data is now freed from a number of the bureaucratic notification requirements, it is now expected to independently ensure effective data protection in all its commercial activities in all areas of the organisation and all products from the very start. Company processes and products should therefore be designed with data protection in mind from early on in the development process.

WHAT DOES THIS MEAN IN PRACTICE?

All companies are required to maintain a register of all the processing activities that occur under their authority. Many companies have therefore already taken a comprehensive inventory of all data processing procedures performed internally. In addition, the GDPR requires every company to document and ensure the legality of all data processing. The processing inventory can also be used to fulfil this central documentation function. Companies must perform a data protection impact assessment for all processing that poses a particular risk for the data subject. A data protection impact assessment must be made, in particular, for any processing, which allows behaviour to be analysed (e.g. consumer behaviour). Moreover, most companies are required to name a data protection officer. Fines can be imposed for failure to comply with these compliance requirements, so that a lack of documentation or the failure to name a data protection officer trigger the risk of fines.

In addition to these general compliance requirements, it is in a company's own interests to ensure that the rights of the data subjects to information, access, rectification, erasure or data portability can be implemented. The new right to data portability, in particular, is a challenge for some start-ups. This right might make it easier for competitors to offer tailor-made offers as it allows them to access the consumer history of new customers. In this respect, customers can demand that their previous provider provide a copy of all data pertaining to them in a commonly-used, electronic format. This means extra effort for companies, but also chances to develop new products.

GDPR IN START-UPS

In addition to taking the general provisions of the GDPR into consideration, start-ups should ask themselves these questions in light of the GDPR requirements and those of the sector:

1. Do your customer contracts and consent forms for data processing meet the requirements of the GDPR?

2. What influence does the GDPR have on your customer regain programmes and other marketing activities?

3. Do your contracts with service providers (e.g. call centres) meet the requirements of the GDPR?

4. Are your company's internal IT processes attuned to the new GDPR? In particular: What do you have in place with respect to data protection? Have you established concepts and routines for erasing the data of data subjects?

5. Do you have processes in place to enable you to react to personal data breaches (hacker attacks)?

6. What special requirements have to be implemented with respect to smart devices?

As far as we can tell, many companies are not 100 percent compliant with the GDPR even three months after its entry into force on 25 May 2018. While the authorities have been tolerant in this initial stage of the "GDPR readiness" in certain areas, companies are expected to take data protection seriously and ensure that compliance levels are high, particularly in the core areas of data processing and the processing of sensitive personal data (e.g. health-apps) of data subjects. However, in our opinion, this "de facto transitional phase" will soon be over.

GDPR SPRINT TIP

If you have not yet started to implement the GDPR or are just at the start of this process, we would recommend that you set the following priorities:

1. **Get an overview of your processes!** Take an inventory of your data protection processes and record them in a processing inventory. This inventory will be the first thing that the authorities ask for.

2. **Deal with your customer related processes and the rights of data subjects!** Unhappy customers and customers, who have a bad experience with data protection, will complain to the authorities. Make sure you fulfil the data protection expectations of your customers.

3. **Deal with customer contracts and information texts!** Authorities can easily take a look at these documents. Make sure that the texts you use are based on the latest GDPR developments.

4. **Look after your employees!** Employee data protection is important and unhappy employees can be a significant data protection risk.

5. **Do the things that are easy to implement!** It is easy to select and appoint a data protection officer and does not take much time.

6. Address the remaining aspects of the GDPR according to your risk priorities.

Dr Axel von Walter
Lawyer | Licensed Specialist for Copyright and Media Law | Licensed Specialist for Information Technology Law
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Paul Wilde
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Corporate Law: The relationship between the investment documentation and articles of association of a start-up

As a rule, numerous agreements will be negotiated and concluded between the existing shareholders and new investors in connection with financing rounds. These include the investment agreement (in the narrow sense, setting out the terms of the investment of the investor) and the shareholders' agreement. The articles of association of a start-up are normally recast or at least amended in relation to the execution of an investment. While only excerpts of the investment and shareholders' agreements need to be submitted to the commercial register, if any, the articles of association of start-ups are publicly available in the commercial register and can be accessed by anyone.

As the parties normally wish to keep certain details of the financing round confidential and depending on the content of the articles of association additional costs for notarial recording and filing with the commercial register occur, there is often a question of which elements of the investment documentation need to be included in the articles of association. This column examines this tension.

THE INVESTMENT AGREEMENT

The investment agreement establishes the conditions for the investor's investment, in particular the extent of the participation, the valuation and amount of the investment (supplementary payments or premiums in addition to the nominal contribution), maturity (closing conditions, milestones), rules for future changes to the shareholding structure (anti-dilution, ratchet) and a catalogue of guarantees and warranties made by the founding shareholders.

THE SHAREHOLDERS' AGREEMENT

In contrast, the shareholders' agreement (in addition to the articles of association) deals with the future relationship between

the shareholders. It establishes the rights of specific shareholders to have representatives on the executive or advisory boards, extends the information and approval rights of investors beyond the statutory standards, and establishes exit rules (restrictions on the transfer, tag-along rights, liquidation preferences, etc.) and management commitments (vesting rules and non-compete clauses). As a rule, this agreement is concluded by all shareholders as a single agreement.

MANDATORY ELEMENTS OF THE ARTICLES OF ASSOCIATION

Some of the typical areas of regulation mentioned above (even if only indirectly) must be included in the articles of association of the start-up in order to be effective. This is true when the start-up takes the legal form of a limited liability company (*Gesellschaft mit beschränkter Haftung, GmbH*). If the start-up is established as a stock company (*Aktiengesellschaft, AG)* or takes this legal form, the requirements are even stricter. Due to the frequency of use of the GmbH form for start-ups, we will now focus only on the requirements of this legal form.

STARTING POINT: MANDATORY AND NON-MANDATORY STATUTORY REQUIREMENTS

The starting point for the catalogue of areas to be regulated in the articles of association of a GmbH are §§ 3 para. 1 and 5 para. 4 of the German Limited Liability Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung, GmbHG*). According to these provisions, the articles of association must include the following elements:

- The company's business name and the place of its registered office.
- Purpose of the company.
- Amount of the share capital.
- Number and nominal value of the shares (only applying to the formation phase).
- Obligations of the shareholders vis-à-vis the company in addition to the payment of the capital contribution (this also affects so-called issuing premiums, providing that these shall have effect from a corporate perspective).
- The object of any non-cash contributions and the nominal share value assigned to those non-cash contributions.
- Any specific term for which the company is formed.

In addition, the GmbHG establishes a number of specific elements; only the articles of association may include reservations or differing rules with respect to these elements:

- The transfer of shares, where this should have the effect of a right in rem (§ 15 para. 4 GmbHG).
- Facilitation of a shareholder resolution about the obligation to pay additional contributions (§ 26 para. 1 GmbHG), deviations from the statutory rules on obligations to pay additional contributions (§ 28 GmbHG).
- Deviations from the statutory rules on the allocation of earnings (§ 29 GmbHG) or on the ratio of distribution for assets upon liquidation (§ 72 sentence 2 GmbHG).
- The redemption of shares by the company (§ 34 para. 1 GmbHG).
- Deviations from certain statutory rules on the executive board (§§ 35 para. 2, 37 para. 1 and 38 para. 2 GmbHG).
- Deviations from the statutory provisions on the rights of shareholders vis-à-vis the company arising under §§ 46 to 51 GmbHG (§ 45 para. 2 GmbHG).
- Formation of a supervisory board (§ 52 para. 1 GmbHG).
- Changes to the majority requirements for amendments of the articles of association and for the winding up of the company (§ 53 para. 2, § 60 para. 1 no. 2 GmbHG).
- Creation of authorised capital (§ 55a GmbHG).
- Stipulation of other grounds for winding up the company (§ 60 para. 2 GmbHG).
- Stipulation of a liquidator other than the directors (§ 66 para. 1 GmbHG).

GREY ZONE WITH CONTRACTUAL AGREEMENTS

It should be noted that it is also possible to conclude a purely contractual agreement – not an agreement under company law – that is not part of the articles of association with respect to some of the matters mentioned above, in particular in the following areas:

- The payment of the premium upon the issue of shares. This is definitely the norm when conducting a financing round because it will prevent the valuation of the start-up from being made publicly available in the commercial register.
- Restrictions on the ability to dispose of shares.
- The establishment of an advisory board, where this board is not granted the powers of an organ of the company and limits its activities, for example, to providing advice.
- A profit allocation formula that deviates from the statutory rule; the same applies to the distribution of assets in the case of liquidation.

However, any contractual deviation from the statutory provisions only binds the contractual parties themselves.

Conversely, certain rules, which may only be contractually agreed and which go beyond the mandatory levels, should also be reflected in the articles of association, such as, for example:

- Drag along obligations, rights of first refusal, etc. in connection with a share transfer stipulation.
- Rules related to the mandatory redemption of shares on settlement so that these are binding on all shareholders – including future shareholders.
- Rights of approval for investors with respect to shareholder resolutions.
- Non-compete obligations.

SUMMARY
In light of the legal and contractual framework that includes the investment agreement, shareholders' agreement and the articles of association, an analysis should be made of which elements must be included in the articles of association in line with the mandatory statutory provisions, as these will be made publicly available in the commercial register and may result in additional costs. Furthermore, it can also be advisable to include certain rules in the articles of association – which go beyond the mandatory levels – although this is not required.

Tassilo Klesen
Lawyer
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Berlin

Valuation of a company: Over and over again: annual valuation of equity investments

When preparing the annual statements each financial year in accordance with commercial law, the legal representatives of a company have to decide whether the assets reported on the balance sheet have retained their value. In this regard, special attention should be given to the assessment of the value of substantial investments. A key topic for investors of start-ups which is worth to know the general framework of the annual valuation of equity investments.

GENERAL PRINCIPLES

Investments are recorded in the balance sheet with their acquisition costs as of the date of acquisition. In the case of an acquisition from third parties, this will include the agreed purchase price and any incidental acquisition costs, e.g. notary costs or capital contributions in the case of a start-up company. It is irrelevant for the classification of a shareholding in a company as an investment under German commercial law whether the shares are held in a corporation or a partnership. The investment is reported in the fixed assets when it is lasting in nature and serves the company's own business. This will normally be the case, where there are no plans to sell the investment.

Shareholdings are not normally subject to scheduled depreciation as they are not moveable assets subject to wear and tear. On each accounting reference date, therefore, an assessment has to be made as to whether depreciation is necessary. German commercial law provides some leeway with the evaluation of shareholdings, as there is only an obligation to report depreciation for a lasting loss in value. Where the loss is not lasting, the company can choose whether to report depreciation. In general, the use or waiver of this option should always be applied consistently over time and in comparable cases, in order to maintain an uniform method of valuation.

It should be noted that "lasting" does not mean permanent depreciation. In accordance with the principle of prudence, in the case of moveable assets, one speaks of a lasting depreciation when, at the point of time in which the annual reports are prepared, there is no specific indication of the recovery of value. Indications of lasting depreciation include, in particular, the lasting erosion of assets or diminished future prospects. On the other hand, weakness in earnings, a deteriorating income situation, economic fluctuations in the sector or mere start-up losses could indicate that the loss in value is only temporary.

SPECIFIC CRITERIA

Devaluation can, or rather must be undertaken when fair value falls below book value. Fair value is not defined in German law. If available, fair value can be derived from the market or stock market price. As this will not normally be possible, fair value is will normally be derived from the earning value or using the discounted cash flow method in accordance with the Principles for the Performance of Business Valuations of the Institute of Public Auditors in Germany (IDW S 1) (see IDW Opinion of the Accounting and Auditing Board on financial reporting, IDW RS HFA 10). Both procedures derive the company value as the present value of future profits and have the same conceptual basis (calculation of the capital value). While the income approach discounts future profits by the relevant capitalisation interest rate, the discounted cash flow method divides the predicted future earnings by the weighted average cost of capital. When the same valuation assumptions are applied, both of these valuation methods recognised in IDW S 1 lead to the same company value. The above-named indications of value are generally already considered in the planning of future profits.

The Institute of Public Auditors (*Institut der Wirtschaftsprüfer - IDW*) in Germany specified in IDW RS HFA 10 which of the relevant aspects must be taken into account for valuation for the purposes of annual financial statements. Underpinning the valuation from a German commercial law perspective is the concept of protection of creditors. Valuations therefore are designed, in particular, to determine whether the company can cover its debts. Possible creditors only have access to company assets. Consequently, the

valuation of an investment must be approached from the point of view of the company writing the financial report. As a result, the only aspects which can be taken into account are synergy effects and measures that are not yet implemented, which the company itself – i.e. including subsidiaries, but not parent or affiliated companies – can implement. In addition, both the corporate taxes at the level of the investment company (which the company own shares in) and the corporate taxes resulting from the inflow to the company preparing the accounts must be taken into account. In contrast, income tax of the shareholders of the company preparing the account should not be taken into account.

Whether and to what extent a precise valuation is necessary, also in light of economic considerations, should in practice be decided on the basis of a prior assessment of the indications, which include the amount of the investment book value. If a positive asset, finance and earnings position prevails, the (proportionate) equity value of the investment company exceeds the balance sheet book value for the investment and there are no reasons for a decrease in future earnings power, a firm valuation may be unnecessary, depending on the book value of the investment. However, if there are any indications of possible depreciation in value, a reliable assessment of the valuation of an investment, with the help of recognised valuation methods, is required. When, for example, an indepth valuation of the investment was carried out the previous year, the business position of the company has remained constant and assumptions about future earnings potential remain unchanged, it can be sufficient to rely on the valuation from the previous year, where there are sufficient hidden reserves.

Moritz Bocks
Tax Advisor
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Dusseldorf

Labour Law: Much to do feat. the autumn flu – working with a doctor's certificate?

Start-ups need a lot of work. They often employ very motivated staff, who are not likely to stay home and miss work when they just have the sniffles. For start-ups, it can be quite gratifying to see employees come in to work and complete their tasks, even when they are "sick". On the other hand, there is the danger that these "sick" employees will infect other staff members, resulting in a higher level of absentees. Still, the question remains from a legal perspective as to how start-ups should deal with "sick" employees.

SICK DOES NOT NECESSARILY MEAN UNABLE TO WORK

A sick employee will not always be incapacitated and unable to work due to their illness, and even if employees notifies their employer that they are ill, there still might not be an underlying illness. Look at the following cases:

- Employees who are on sick leave and do not work. The German Continued Remuneration Act (*Entgetfortzahlungsgesetz - EFZG*) applies to this standard legal case.
- Employees who are ill (e.g. a slight cold), but who are not incapacitated by the illness and still go to work.
- Employees, who are not ill but "call in sick"; this is an abuse and a serious breach of their duties.
- Employees, who are on sick leave and have presented their employer with a doctor's certificate, but feel that they are healthy again before the end of that sick leave and want to go back to work. Is this allowed?

GENERAL PRINCIPLE

Employees on sick leave are not obliged to perform their work, nor is it necessarily possible for them to do so. Employees on sick leave are therefore "excused". Sick leave is an exemption to the general principle of "no work, no pay". The German Continued Remuneration Act grants employees the right to claim continued pay in the case of illness for a period of up to six weeks (§ 3 EFZG). In contrast, employees have a duty to perform their work when they do not have sick leave. Once an employee's sick leave ends, the employee must report back to their employer without delay and offer their services again. This can also be accomplished simply by returning to work.

SICK CERTIFICATE VERSUS HEALTH CERTIFICATE

Under the German Continued Remuneration Act, employees must provide their employer with a doctor's certificate evidencing their incapacity to work and the expected duration of this incapacity on no later than the third day of sick leave. The employment contract can stipulate that a doctor's certificate must be provided to the employer for the first day of any sick leave onwards. Pursuant to § 5 para. 1 EFZG, the doctor's certificate must also state the expected duration of any sick leave. This will be based on a doctor's prognosis; the employee may be unable to work for a shorter or longer period of time than is stated on the certificate. The doctor's certificate is merely the employee's evidence that she or he is ill and unable to work. An employee who has sick leave may go back to work before the end of this leave – even without a "health certificate". A doctor's certificate is not a ban on working and is based on a prognosis made at the beginning of an illness. An employee may in fact feel fit again before the end of the sick leave. While it is possible to obtain a doctor's certificate of health, employment law provisions do not establish a duty on employees to obtain such a certificate.

DUTY OF CARE OF START-UPS AS EMPLOYERS

A start-up has various duties of care. If a start-up has knowledge of an employee's actual incapacity to work, it may neither demand unreasonable performance nor knowingly accept such work. Instead, in accordance with a 1988 judgment of the Regional Labour Court (*Landesarbeitsgericht*) in Hamm, the employer must instead prevent the employee from working. Where appropriate, employees may provide their employer with assurance, in writing, that they are able to work. However, an employer is still not justified in accepting work from an employee who is clearly incapacitated. The employer must take into account not only its operational interests and the interests of the employee in question, but also the interests of the other employees (risk of infection, etc.).

LIABILITY / INSURANCE COVER

Start-ups can also rest assured on the issue of liability and insurance cover, when employees, who are sick, perform their work. Insurance covers employees who go back to work, despite the fact that they have a doctor's certificate that still grants them sick leave. This applies both to accidents occurring on the way to or from work and to accidents at work.

Still, if an employer breaches its duty of care, i.e. it allows an employee to work despite knowing of the employee's incapacity to work, and an accident occurs because of this incapacity (e.g. dizziness as a symptom of high fever), liability can shift from the insurance company to the employer.

Dr Michaela Felisiak
Lawyer | LL.M.
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Dr Erik Schmid
Lawyer | Licensed Specialist for Labour Law
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Munich

Imprint

This publication is issued by
BEITEN BURKHARDT
Rechtsanwaltsgesellschaft mbH
Ganghoferstrasse 33 | D-80339 Munich
Registered under HR B 155350 at the Regional Court Munich/
VAT Reg. No.: DE811218811

For more information see:
https://www.beiten-burkhardt.com/en/imprint

EDITOR IN CHARGE
Christian Philipp Kalusa | Lawyer

PLEASE NOTE
This publication cannot replace consultation with a trained legal professional.

If you no longer wish to receive this newsletter, you can unsubscribe at any time by e-mail (please send an e-mail with the heading “Unsubscribe” to newsletter@bblaw.com) or any other declaration made to BEITEN BURKHARDT.

YOUR CONTACTS

BERLIN
Luetzowplatz 10 | 10785 Berlin
Dr Christian von Wistinghausen | Lawyer | LL.M.
Tel.: +49 30 26471-351 | Christian.Wistinghausen@bblaw.com

DUSSELDORF
Cecilienallee 7 | 40474 Dusseldorf
Dr Anja Krüger | Lawyer | Mediator
Tel.: +49 211 518989-135 | Anja.Krueger@bblaw.com

FRANKFURT AM MAIN
Mainzer Landstrasse 36 | 60325 Frankfurt am Main
Dr Gesine von der Groeben | Lawyer
Tel.: +49 69 756095-393 | Gesine.vonderGroeben@bblaw.com

HAMBURG
Neuer Wall 72 | 20354 Hamburg
Torsten Cülter | Lawyer
Tel.: +49 40 688745-118 | Torsten.Cuelter@bblaw.com

MÜNCHEN
Ganghoferstrasse 33 | 80339 Munich
Dr Mario Weichel | Lawyer
Tel.: +49 89 35065-1303 | Mario.Weichel@bblaw.com