Corporate Venture Capital 2017

Structures
Challenges
Success Factors
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This story illustrates that disruptive innovations can replace established companies or even entire markets. In a time of ever-shorter innovation cycles and the increased digitalization of many value-added chains, established businesses need to constantly evolve and reinvent themselves, and even go so far as to rethink their own core business.

Corporate Venturing, especially Corporate Venture Capital (CVC), can play a key role in the corporate innovation portfolio. CVC is the financing of innovative startups by established corporate investors. CVC offers corporate investors the opportunity to access new technologies and trends, and to gain important experiences in new market segments. If Corporate Venturing is implemented properly, it can also help nurture the corporate’s intrapreneurship initiatives and offer attractive alternative development opportunities to the corporate’s top talents.

In 2016, there were record high levels of CVC investments in the United States. According to KMPG, over 53 new CVC dedicated units made their first investments in the first half of 2016 alone.

"Stay Hungry, Stay Foolish"

“What use could this company make of an electrical toy?” In 1877, the CEO of the Western Union Telegraph Corporation, the biggest company in the United States at the time, used these words to reject a low-priced offer to buy the rights to an invention created by a Scottish teacher of the deaf and mute. The inventor went on to found his own company with the help of private investors. His invention? The first practical telephone. Alexander Graham Bell established what would become the world’s largest private telecommunication group: AT&T.
And it’s not only corporate investors from the technology and pharmaceutical sectors that are investing in startups, but players from more traditional sectors as well. For example, United States-based General Mills and Campbell’s Soup have recently launched their own CVC units. The number of CVC investors is also increasing in Germany, as more medium-sized companies are becoming open to the idea of innovative investments. In early 2016, for instance, our client Aesculap, an international leader in medical technology, helped to establish Neuroloop, alongside the Technology Transfer Office of Freiburg University and an academic founding team. Neuroloop will develop an innovative neurostimulator technology in an agile startup environment. This was one of the largest university spinoffs in Germany to date.

With our long-standing experience in global CVC investments, we want to share our insights into the structures, challenges, and success factors of CVC from a lawyer’s perspective.

We hope you enjoy this brief brochure. If you would like to discuss it further, please do not hesitate to contact us. We constantly strive to reinvent and redefine ourselves together with our clients.

Your Orrick Team

Dr. Sven Greulich LL.M., EMBA (Kellogg/WHU)
Partner, Technology Companies Group,
Düsseldorf
sgreulich@orrick.com
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1 Introduction: Corporate Venturing and CVC

Developing new technologies and opening up to new markets is expensive and risky. Therefore, corporate investors must be selective when deciding how to innovate. Corporate Venturing is one way to do this. The aim of Corporate Venturing is to identify key developments in existing and new markets, and to use these developments profitably. Aside from obvious financial objectives, there is also a focus on strategic objectives for the corporate, such as accessing new technologies and research and development capacities, increasing the flexibility of the company’s organizational structure, and tapping into new talent pools.

Innovation as an Imperative

In order to secure a competitive advantage in the short term, corporate investors must constantly improve their products and services. But in order to be successful in the long term, efficiency-enhancing measures alone will not suffice. Companies and entrepreneurs that maintain or revive their agility and pioneering spirit have a better chance of being successful.

Despite knowing this, many companies do not embrace disruptive change. Organizational psychology tells us that through gradual success and growth, executives tend to behave increasingly risk averse, and are likely to govern their company towards the overall continuation and protection of the core business. Therefore, in-house innovations tend to be of a sustaining and incremental nature rather than disruptive.

This kind of thinking is dangerous. Harvard Business School Professor Clayton Christensen demonstrated this in his seminal work, “The Innovator’s Dilemma” (Harvard Business Review Press, 1997). He talks about how risk aversion, internal focusing, and preserving the status quo are dangerous to companies. These risks threaten major international and medium-sized companies alike.

Here, structured cooperation with startups, in whatever shape or form, can fuel innovation. We have seen this in the media industry where arguably Axel Springer is best known for its successful digital transformation through investing in and acquiring dozens of startups over the last years. But nowadays this applies more broadly to other sectors of the economy.
"Lawyer, Disrupt Thyself!"

This is what Sarah Reed, General Counsel of the Venture Capital Investors CRV, said in a piece for TechCrunch in March 2014. Rightfully, she complained that irrespective of the changing markets, law firms are still too reluctant to embrace innovation. As one of the world’s leading technology law firms, Orrick took up these challenges at an early stage.

When Y Combinator created its new form of early start-up financing known as Simple Agreements for Future Equity (SAFEs), we helped implement it with many of our clients. With SAFE Y-Combinator created a more flexible and efficient alternative to convertible notes used in capital raising that has been quickly adopted by the market.

Orrick uses Clerky for many of its clients – Clerky is a startup founded by former Orrick TCG attorneys that helps startups get legal paperwork done safely through powerful software and support.

Orrick is the legal advisor to Stripe Atlas which strives to give entrepreneurs access to the basic building blocks for starting a global internet business.

Questions can be directed to:

Dr. Johannes Rüberg
Corporate/M&A
jrueberg@orrick.com
Corporate investors that want to work with startups, however, face three challenges in today’s market:

• Corporate investors must actively seek, follow, and assess the many cooperation possibilities and developments, as the international startup ecosystem is rapidly growing. This requires developing the necessary scouting and deal-making capabilities in-house, as well as quick decision-making processes. CVC should not be treated as a fashionable trend but rather a key responsibility of top management. Only the professionalization of one’s own in-house capabilities and a credible long-term vision will create trustworthy relationships with founders and open attractive coinvestment opportunities with other established market participants. A good coinvestor can add significant value, as it not only reduces a corporate’s economic risk, but also brings complementary skills to the table. From the viewpoint of the startup founder, coinvestors can also limit the risk of opportunistic behavior of the corporate investor.

• Corporate investors have to clearly demonstrate the value they can offer to a startup, as startups have more financing options now than ever before.

• Corporate investors have to be clear on why they want to invest in a startup. Corporate investors should understand whether their investment is primarily strategic or primarily financial, and how conflicts between strategic and financial goals shall be resolved. This applies not only to the structuring of investments but also to the incentive structures for the corporate’s own investment team.
This is one reason why pairing with a startup can be a good idea for a corporate — through CVC, a corporate can remain in sync with what’s current.

We’ve seen this in our own work. In late 2015, the Bosch Group acquired a stake in RE’FLEKT, a Munich-based startup and a leader in the fields of augmented and virtual reality solutions for industrial applications. Our partner Sven Greulich has advised

Startups and Corporate investors: an Ideal Combination?

Innovations can be developed from within an established company’s existing structure. Mark Zuckerberg embraced this idea when in the early years of Facebook he developed the motto, “Move Fast and Break Things.” But it’s more often the case that startups move faster than established companies. Unburdened by organizational and structural restrictions, they tend to have a greater appetite for risk. Young entrepreneurs often possess special skills and know-how from which the corporate investors can profit.
RE’FLEKT since its founding in 2012. Bosch and RE’FLEKT jointly developed the platform RE’FLEKT ONE, the world’s first software platform for the industrialization of technically augmented reality applications. “Bosch invested to secure access to technology and know-how for a highly promising market,” says Wolfgang Stelzle, cofounder and CEO of RE’FLEKT. “Of course, ideas for innovation also exist in large companies. However, due to the fast pace of technological developments, the corporate profits from agile and flexible partners who have special knowledge when they aspire to make an idea reach market maturity.”

For the same reasons, several corporate investors run “intrapreneurship” programs that are very successful and demonstrate that the entrepreneurial impulse does not necessarily need to originate from external startups. These programs allow internal employees to develop innovations in separate startup-like structures outside of the company. Thus, the corporate investors can use the innovations to their strategic advantage (e.g., by reintegrating the startup at a later stage) or make a profit by selling the innovation or the startup to the market. Nowadays, founding a startup or working for one is an attractive career option for talented students. Moreover, cooperations with startups and credible intrapreneurship programs help the corporate gain access to this talent pod.

On the other hand, what can a corporate offer a startup? Aside from capital, it can offer an organizational structure and institutional stability, stable operations, and access to customer markets. Investments from a reputable CVC investor can transfer credibility and help the startup overcome the liability of newness. A corporate can also offer strong professional networks and access to domain expertise, know-how, technology, and its sales channels.

Yet the story of Corporate Venturing, which began in the United States in the 1960s, is a spotted one. Despite this seemingly ideal matchup, many partnerships between corporate investors and startups do not fulfill expectations. We’ll discuss this in greater depth later.
The Types of Corporate Venturing

First, we will start with a brief overview of the different types of Corporate Venturing. For corporate investors and startups alike it is important to identify the right type of partnership structure from the start. Corporate Venturing can be classified using the following two questions. The first one is about the degree of the cooperation and control, i.e., will the company acquire an equity stake in the startup? The second is about the flow of innovation, i.e., will external potential be integrated into the corporate (“Outside-In”), or will innovation capacity be developed through an external platform outside the corporate structure (“Inside-Out”)?

The answers to these questions offer four prototypical structures of Corporate Venturing, which are outlined below. The transitions are overlapping, as there are many indirect types of cooperation, including making indirect investments through funds such as Project A Ventures or the Hi-Tech Gründerfonds (HTGF).

**Startup-Programme (Outside-In)**

Besides “classic” Corporate Venturing activities such as CVC and incubators, which include equity investments, looser types of cooperation have recently emerged in which the corporate collaborates with several startups without taking a stake in them.

Some of these startup programs follow the Outside-In approach. The company offers the startups the opportunity to collaborate on projects with the corporate’s expert teams. This frequently occurs at coworking spaces provided by the corporate. Often, the contract between the parties is in the form of a joint-development agreement which establishes provisions regarding property rights (IP), financing, and the subsequent marketing of the project’s outcomes.

If the project is successful, the startup becomes a supplier for the corporate. By example, programs such as “Technology to Business” by Siemens or “Digital Accelerator” by the Allianz Group offer the startup a path to the commercialization of their own technology or business idea and establish a gateway to a globally operating company.

**Startup-Programme (Inside-Out)**

In this model, the corporate opens a platform outside of the company using its own technology so that startups can develop and commercialize their products and services. Such Inside-Out programs aim to extend the market for the corporate. Each individual startup strengthens the entire platform through interactions with other startups, as well as the clients and the suppliers.

One of the most well-known examples is the App Store (iOS) by Apple with millions of applications. Another example is PayPal, which offers numerous startups efficient and standardized processes through its “Startup Blueprint” program to implement the PayPal technology in the startup’s own product developments. In the German Fintech sector, Sutor Bank has followed suit with similar startup cooperation models.
Corporate Venture Capital

In a traditional CVC, a corporate participates directly in an external startup, with a number of possible structures outlined below.

Although this structure leads to higher search and transaction costs, direct participation gives the corporate immediate control and greater involvement. Additionally, an equity stake offers the largest financial upside in case of an exit. From the perspective of a strategically motivated corporate, they can use their position as a co-shareholder and their knowledge of the startup to take over strategically interesting startups at a later point in time. For example, in early 2014, Google acquired Orrick’s client, Nest Labs, for USD 3.2 billion. Prior to this, GV (formerly Google Ventures) had purchased a stake in Nest Labs through a CVC investment and watched the development of the startup until its takeover through the parent company.

CVC offers a particularly important source of financing, notably for technology-focused startups. A less scalable business model, long production cycles, and the low number of realistic partners available for an exit all make them less attractive to classic Venture Capital investors.

Apart from financial contributions, the startup usually receives access to other important resources, including procurement and sales channels, marketing capacities, expertise, and research and development (R&D), which are resources that can prove to be very beneficial to startups. For example, studies of the U.S. market show that technology-focused startups that have a strategically motivated CVC investor are more innovative and ready to take on risks. However, these startups tend to be less profitable in the first years than the ones financed by classic Venture Capital investors (Chemmanur/Loutskina/Tian, Corporate Venture Capital, Value Creation and Innovation, Review of Financial Studies, 2014).

On the other hand, having a corporate in the cap table may limit the startup’s ability to quickly adapt and may possibly hinder or delay a necessary pivoting. The same applies to cooperation options with the corporate’s competitors and the chance to “exit” to such a competitor. Such issues should be discussed openly between founders and investors and specified in contractual agreements if necessary. Corporate investors are well advised to proactively address these concerns of the founders to avoid unpleasant surprises down the road and burning their reputation as a reliable partner to accelerate a startup’s development.

Illustr. 1: Types of Corporate Venturing (Based on Weiblen/Chesbrough, Engaging with Startups to Enhance Corporate Innovation, California Management Review, 2015).
Unlike CVC investments, numerous incubator programs set up by corporate investors follow the Inside-Out approach. Ideas brought forward by the corporate’s employees that are not suitable for the corporate’s business model are further developed by the incubator and will either be used strategically by the corporate later on or will be monetized through an exit.

Even when innovations are similar to the existing business model, development outside of the rigid structures of the parent company may be helpful to test new technologies faster and to receive feedback from potential users as quickly as possible.

Employees with an entrepreneurial mindset may then jointly, with their corporate employer, create a startup, which receives a budget and is allowed access to the company’s other resources. Such startups are frequently designed for a future takeover by the corporate or designed to be reintegrated into the company.

**Incubators**
CVC and “Classic” Venture Capital

To distinguish between CVC and the “classic” Venture Capital (also known as Independent Venture Capital, “IVC”), many observers stress the (supposedly) different investment objectives. While IVC investors exclusively pursue financial goals, and usually use third-party funds in this pursuit, CVC investors usually follow a strategic plan that can sometimes conflict with the financial aspects. These “strategists” invest in young and innovative businesses to gain access to new technologies in order to enter new markets. For this kind of investment, synergies between investors and startups are often paramount.

CVC activities may cause conflicts between internal stakeholders. Our experience has been that sometimes corporate investors perceive the startup as an “infant group company” that needs to be minded. This applies particularly to strategically motivated investors. By overmonitoring the startup, the startup loses the ability and willingness to take risks. Financially motivated investors, however, tend to grant the startup greater freedoms.

Even though many CVC investors try to simultaneously follow strategic and financial goals, founders and investors are equally advised to prioritize among these goals. Concepts and mechanisms that are usually employed in classic Venture Capital investments may not be suitable if the investment mainly serves strategic purposes. A strategically motivated CVC investor should pay attention to the conditions under which the investor may gain access to the startup and its technology. If an investment is designed for an exit to the CVC investor or if such an exit is a likely option, both parties should address questions regarding a potential future integration in the Shareholders’ Agreement.

Even with these caveats, the distinction between strategic and financial goals need not be overemphasized, as sometimes they change over time. Some CVC investors clearly have dominating financial objectives. In a low-interest environment with simultaneously high valuations in the M&A market, companies may use their usually high-liquidity reserves for investments in startups with potentially above-average returns. Other CVC investors have over time dissociated themselves from strategic investments and now (almost) exclusively pursue financial goals (examples for the German market are Vorwerk Direct Selling Ventures and Holtzbrinck Ventures).

Another often cited difference between CVC and IVC investors is the investor’s timeframe. It is often claimed that CVC investors have a longer investment horizon. While the lifetime of many IVC funds is usually limited to ten years (often with an option to extend for another two years), CVC investors can hold their investments (at least theoretically) for an unlimited amount of time. In practice, this long-term orientation is questionable. Empirical studies show that the investment activity patterns of CVC and IVC investors are remarkably similar and cyclical. In times of economic crises, CVC investments generally decreased or completely came to a halt, just as IVC investments.
Though Michael Brigl, partner at Boston Consulting Group, is sure that “Corporate Venture Capital is here to stay,” as many corporate investors, due to the slow growth in existing markets (and the increasing pressure to innovate), rarely have other opportunities to invest in future markets other than investing in startups. The corporate investors’ current high liquidity reserves, in comparison to earlier CVC cycles, support this assessment.

However, in our opinion, it requires the involvement of the top management of a corporate in its CVC investments and adequately aligned incentives within the corporate’s organization to ensure a long-term investment focus.

<table>
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<tr>
<th>Main Aim(s)</th>
<th>CVC</th>
<th>Corporate Incubator</th>
<th>Startup Program (Outside-In)</th>
<th>Startup Program (Inside-Out)</th>
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<tbody>
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<td></td>
<td>• Financial returns</td>
<td>• Marketing of technology separate from the main company</td>
<td>• Product innovation</td>
<td>• Developing and strengthening the platform</td>
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<tr>
<td></td>
<td>• Immediate control</td>
<td>• Financial returns</td>
<td>• First-Mover advantages</td>
<td>• Gaining future customers</td>
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<td></td>
<td>and greater involvement</td>
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| Equity Participation         | always                     | normally                                                 | usually never                         | usually never                            |
| Scope (Number of Startups)   | low                        | low                                                      | medium                                | high                                     |
| Interrelationship with the Main Company | usually low            | medium                                                   | high                                  | medium                                   |
| Closeness to the Main Company | medium                    | medium                                                   | high                                  | low                                      |
| Extent of Support for the Startup | medium                | high                                                     | medium                                | low                                      |
| Value Added                  | business partnership       | business partnership                                     | product sales                         | fees, commission                         |
| Organization of the Involvement | independent venture capital branch, executive level | independent development unit | independent innovation unit | independent branch office, corporate development |
| Participation Timeline       | long term                  | long term                                                | short term                            | medium term                             |
| Integration of New Startups  | due diligence              | usually company's own                                    | open                                  | very open                               |

Illustr. 2: Types of Corporate Venturing in comparison (Based on Weiblen/Chesbrough, Engaging with Startups to Enhance Corporate Innovation, California Management Review, 2015).
Market Trends and CVC in Germany

Though exact figures are difficult to come by, there are a few dozen active CVC investors in Germany and these numbers have steadily increased over the past several years. Most recently, AXA Strategic Ventures, CommerzVentures, and DroegeVentures joined the club. The entrance of even more participants in the market is expected soon. Through our practice, we know that larger, medium-sized machinery and plant engineering businesses are currently considering CVC investments to position themselves for what is often dubbed the so-called Industry 4.0 revolution. The consulting company EY noted in its 2015 “VC Trends Initiative” analysis a “fundamental mindset change in corporate investors” pushing them more and more towards CVC investments.

According to information from London-based Global Corporate Venturing, the number of public CVC investments in Germany nearly doubled in the past several years; it increased from 22 in 2011 to 42 in 2015. Other sources, such as Berliner VC Report, provide even higher numbers for 2015. The actual number is in fact most likely higher, as corporate investors in Germany — in contrast to corporate investors in the United States — publish their transactions less frequently.

The current appetite for CVC investments may not be sustainable when company valuations come down and the IVC investors’ readiness to invest decreases.
On a Side Note: An Overview of Acqui-Hiring

Creative, competent and entrepreneurial employees are often a startup’s most valuable asset. The so-called acqui-hiring can provide a good opportunity for corporate investors to gain their know-how and innovative spirit.

Acqui-hiring describes the acquisition of a startup with the (often primary) goal to onboard its employees who have already proven their professional competency and their ability to perform as a team. Thus, the buyer brings on an efficient team in a manner that is less costly than “traditional” headhunting.

In acqui-hiring, the buyer is mainly interested in the key employees’ expertise, so it is of crucial importance to convince all key employees of the merits of the transaction. If any of them are not satisfied with the incentives, their discontent may affect other members of the team and put the whole undertaking at risk.

The buyer should also bear the shareholders’ interests in mind (especially business angels and venture capitalists), as a major part of the acquisition funds is often used to incentivize the founders and employees and, as a consequence, the shareholders will not always achieve the expected return on equity.

Acqui-hiring can be structured as a share deal or as an asset deal. In case of an asset deal, sec. 613a German Civil Code and similar provisions under foreign law need to be taken into account: these entitle the employees to object to the transfer of their employment relationship. It is therefore advisable to respond to the employees’ needs early, preferably ahead of the preparation of the transaction documents. Waivers regarding the right of objection can provide legal certainty.

One word of warning: young companies do not always adhere to the regulations of the German Law on Employee Inventions and similar foreign law rules. While requesting indemnification undertakings in the transaction documentation is one way to address this, cleaning up any legacy issues in the course of the acqui-hiring might be a better approach to avoid future disagreements with key employees.

Another important concern is the long-term retention of the employees, since they are the actual reason for the transaction. Suitable non-competition undertakings and a well-designed long-term incentive program are essential tools to make acqui-hiring work.

Questions can be directed to:

Dr. Fabian von Samson-Himmelstjerna
Partner, M&A and Private Equity
fsamson@orrick.com
2 CVC Investments

Equity investments by CVC investors in startups are set up as long-term partnerships and rely on cooperation between the parties. This holds true already for both the due diligence process and negotiation phase. Founders and investors must find a sustainable, balanced agreement that addresses the concerns and needs of all stakeholders.

The Investment Process

Once the investor’s interest is confirmed and the parties agree on a valuation (at least within a certain range), the key commercial aspects regarding the investment and basic rights and duties of the investor are usually summarized in a term sheet (also known as a letter of intent, memorandum of understanding, or heads of terms). In particular, when dealing with strategically motivated investors, the founders will also insist on strict confidentiality undertakings by the corporate regarding information that will be received in the due diligence process and a non-solicitation obligation of the corporate regarding the startup’s employees.

This is followed by the corporate’s due diligence assessment of the startup. If the startup is young, this will be limited to an assessment of the founders and the market, and an examination of the developmental work that has taken place to date. Often, the due diligence will focus on the startup’s technology, although the corporate may want to also review IP matters. If the startup has already been incorporated and is beyond the early developmental stages, then the due diligence process will be more extensive. Founders should know the key focal points their potential future CVC investors will focus on and pay proper attention to them early on. This is especially important for the areas of IP, “corporate housekeeping”, data protection and other compliance aspects.

After the term sheet stage, two agreements will be entered into with the founder: the Investment Agreement and the Shareholders’ Agreement. The Investment Agreement contains details of the mechanism for how the corporate invests into the startup (e.g., issuing of shares by means of a capital increase or negotiation of convertible loans, as well as financing milestones). It also specifies guarantees granted by the founders and the startup and legal consequences in case of a breach. Corporate investors should be aware that a startup investment differs from negotiating “normal” corporate acquisitions and this applies also to appropriate remedy provisions. Here, an agreement on a compensatory capital increase instead of the payment of damages in cash as normally agreed upon in M&A deals may be more adequate.
A Quick Summary: Intellectual Property and Data Protection

Startups often make significant mistakes in relation to their intellectual property rights (IP) that can later lead to hefty monetary burdens. It is therefore important to appropriately protect the startups’ own IP from the beginning.

This includes the overall registration of brands and web domains, among others. Sectors and markets that are only relevant at a later date should not be excluded. It may be useful to register a brand, not only in one country, but as an EU Trademark in all European Union member states. These measures prevent IP conflicts resulting from subsequent market entry in other countries and are preventive against copycats and freeriders. The same applies to web domains. These should also be registered, bearing in mind the international perspective, e.g., for several top-level domains.

New data protection laws will be enforced within the European Union within two years. Compliance with legal guidelines will be supervised more strictly, and fines will be increased to 4% of the company’s annual global turnover. These changes pose a serious risk for every business.

Technologically innovative startups that process personal data in the course of their services should especially observe the basic rules of Privacy by Design and Privacy by Default. Attention should be paid during the early stages that the final product or offered service complies with the fundamental principles of data minimization, and that appropriation of a product is created that is in line with Privacy by Default settings. Noncompliance with data privacy and cybersecurity laws could result in the inability to compete in the European Market.

Questions can be directed to:

Dr. Christian Schröder
Partner, IP/IT, Technology Companies Group
cschoeider@orrick.com
The Shareholders’ Agreement sets forth the rights and duties of the future co-shareholders. Relevant provisions often include the following:

• Contribution of assets (e.g., IP — in particular if to be jointly created — as well as agreements about future inventions and innovations).

• Composition of the board of management and the advisory board.

• Rights of control, information, and veto for the corporate.

• Vesting of the founders’ shares and provisions regarding good and bad leavers of the founders, as well as call options in favor of the investor (possibly complemented by appropriate redemption provisions in the articles of association).

• Antidilution rules in case of future down rounds.

• Agreements regarding the exit, including allocation of proceeds in case of an exit, and potentially the corporate’s rights to (gradually) take over the startup.

• Lock-up periods, preemptive rights, rights of first offer, joint rights of sale (tag along) and joint duties of sale (drag along).

• Business relationship with the corporate and possibly the usage of the startup’s IP (licensing and cross-licensing).

• Services to be provided by the corporate, such as IP management, HR, and accounting or payroll services.

The Shareholders’ Agreement complements the articles of association in case of a GmbH and an UG (haftungsbeschränkt), which are the most common legal structures for startups in Germany. Unlike the articles of association, the Shareholders’ Agreement does not fall under “register publicity” and is therefore not published in the commercial register; this is the place for confidential provisions.

In practice, the Shareholders’ Agreement and Investment Agreement are often drafted as one contract, especially in the case of a joint establishment of the startup. Both agreements will normally need to be notarized, at least if the startup is a GmbH or an UG (haftungsbeschränkt).
Possible Structures of an Investment

The ideal form of corporate investment is determined by the facts of each case and depends on where the startup is in its life cycle.

In a very early stage, the corporate might establish the startup together with the founders. This is often the case in incubator programs and university spinoffs. The corporate pays its financial share by taking over its portion of the initially issued shares and paying a premium in terms of para. 272 sec. 2 no. 1 German Commercial Code or, as we recommend, by paying an additional payment into the capital reserve in terms of sec. 272 para. 2 no. 4 German Commercial Code.

When the corporate invests in already established startups this can be structured through a share capital increase against payment of the newly issued shares in cash and a further payment into the startup’s capital reserves. The corporate may, alternatively or cumulatively, grant the startup a (convertible) loan. Payment of the loan amount often takes place in installments that depend on achievement of certain milestones in order to minimize the CVC investor’s risks.

Loans can be issued with and without a conversion option. A convertible loan can be converted in later financing rounds into shares based on the valuation of that future financing round minus a discount (often between ten and 20%). Structuring an investment through a convertible loan can often help avoid difficult discussions about valuation in the early stages of the startup and defer them to the next rounds of financing when third-party investors validate the startup’s valuation.

Parties involved in CVC investments should consider how realistic follow-on financing rounds and an external valuation of the startup are. Otherwise, separate valuations for a (staged) takeover of the startup by the corporate can be agreed upon. Valuation ranges can be made subject to the fulfillment of business plans or on the achievement of certain technical or other milestones. This can help make the potential dilution as predictable as possible for the founders.
Merger Control

Some CVC investments may be subject to merger control. In such cases, the transaction will need to be reported to and cleared by the competent competition authority (or authorities) before it may be implemented. Whether or not a merger filing is required usually depends on two questions:

• Does the investment constitute a “concentration” within the meaning of the merger control rules?

• What are the revenues of the undertakings participating in the concentration?

On the first question, a transaction usually qualifies as a concentration if a share of 25% or more of the equity or the voting rights in a company is being acquired. Below this threshold, an investment in another company may constitute a concentration if it confers a “competitively significant influence” upon the acquirer. This may be the case, for example, if the acquirer obtains certain veto rights or has the power to appoint representatives to the executive or supervisory boards of the startup.

Regarding the second question, a filing is required if the “undertakings concerned” meet the statutory turnover thresholds.

For German merger control purposes, these are:

(a) EUR 500 million worldwide in relation to all parties concerned,

(b) EUR 25 million in Germany in relation to one party, and

(c) EUR 5 million in Germany in relation to another party.

Because most startups do not reach the threshold of EUR 5 million, CVC investments are usually not subject to a merger filing requirement. However, the term “undertaking” includes all entities and persons under common control, i.e., the entire group of companies to which a company involved in the transaction belongs. In addition, the undertakings concerned are not only the CVC investor and the startup (and their affiliates), but also other potential shareholders holding 25% or more of the shares in the target or that control the target (alone or jointly with other parties).

Determining whether or not a transaction needs to be filed with the German Federal Cartel Office, therefore, requires a careful analysis of the transaction structure and the corporate governance of the startup, as well as information on the revenues generated by the parties participating in the concentration. This becomes even more important when the activities of the startup are not limited to Germany, so that in addition to German merger control, the relevant rules in other jurisdictions need to be considered.

It is expected that starting in mid-2017, the scope of application of the German merger rules will be expanded by the introduction of new filing thresholds to capture transactions that have not previously been subject to merger clearance because the startup’s turnover had been less than EUR 5 million (see below Antitrust Reform as an “Anti-Exit Law”). We’ll be closely monitoring this development.
Flips: an Option for CVC?

In the startup sector, “Flip” refers to the transfer of a startup into an American legal structure. In this process, the shareholders swap (“flip”) their shares in their German startup company for shares in an American company (often a Delaware corporation), which then becomes the new holding company of the startup.

A central motive for the Flip is that the startup receives improved access to the significantly more liquid U.S. Venture Capital market, which can lead to a higher valuation.

The benefits also bring with them the cost of a more complex and consultation-intensive structure of the startup, as well as an issue under German taxation law. This is because the American Flip is treated as a sale under German taxation law, and accrued hidden reserves in the startup shares are revealed. Additionally, the issue of exit taxation needs to be taken into account if the startup’s management moves to the United States.

From a CVC investor’s perspective, a Flip would not be attractive if the investor wants to finance the CVC project with its own financial means, or if the corporate wants to integrate the startup in the long run. If, however, raising capital in the U.S. or selling the company to a U.S. buyer are realistic options for the CVC investor, and the business idea of the startup is particularly appealing to the U.S. markets, then a Flip of the startup can be an interesting option.

Questions regarding Flips (and other taxation queries) can be directed to:

Dr. Stefan Schultes-Schnitzlein
Partner, Tax Law
sschnitzlein@orrick.com
Tax Implications

When preparing a valuation in anticipation of an investment, the founders are interested in getting a high valuation on the premise that the investor will make a higher financial contribution. At the same time, the founders want to continue to retain ownership of as much of the company as they can. The problem for founders with this approach is that, in many cases, founders do not contribute any relevant assets apart from their ideas, skills, and the promise of great personal efforts. In some cases, certain assets, such as patents, other IP rights, or software developments, can be supplied by the founders.

This asymmetry between founders’ contributions and an investor’s contributions may cause undesired tax implications for the founders. Taxes can arise by uncovering hidden reserves in assets brought in by founders. Additionally, a gift tax may be imposed on the founder if the investor accepts an economic dilution in return for the founders’ contribution. In contrast to other transactions with experienced and financially savvy business partners, the CVC investor also has to bear the tax-planning interests of the founders in mind: The founders usually do not have enough money to pay taxes triggered by the investor’s investment in the startup. In order to allow the founders to work unburdened, which is in both parties’ interest, the CVC investor should be prepared to help the founders avoid unpleasant tax surprises.

Certain models reduce the tax risks for the founders, such as exit and liquidation preferences in favor of the corporate investor. This often occurs in combination with the corporate’s waiver regarding certain tax advantages; hence, no “step-up” will occur and the startups’ depreciation base will remain low.
3 The “Right” Corporate Governance

Once a corporate investor agrees to make a CVC investment, we see that issues repeatedly arise when the day-to-day operations and needs of a startup conflict with its CVC investor’s corporate culture. The strict division of responsibility on the side of the corporate can lead to an exhaustive decision-making process and lukewarm compromises, both of which tend to frustrate founders, who are used to acting quickly and enthusiastically. Putting into place thought-out corporate governance structures can allow the startup to remain creative and flexible, while still giving corporate investors some peace of mind.

Corporate Governance

The corporate governance structures of many corporate investors are designed to lead large, international operations, and are often standardized, which make them a poor fit for the special needs of a startup. In the worst cases, this can suffocate the founders’ agility.

It cannot be overemphasized how important the direct involvement of the top management in CVC activities is in order to protect the startup from the organizational inertias and particular interests of the various business units. The startup is not an “infant” group company and can thus not be managed like one.

Executive Management

In order to fill competency gaps on the founders’ team, the corporate might request the right to appoint a managing director of the startup.

However, corporate investors should critically assess whether the management needs of the startup can be adequately addressed by their standard rules of procedure and whether they should really be applied to the startup.

• For example, there are often elaborate rules of procedure for the calling, preparation, holding, and documentation of meetings, which are usually too rigid for the dynamic environment in which the startup is operating, at least in the early phases. In general, the implementation of a responsibility matrix with strictly separated job titles and areas of responsibilities that many corporate investors are used to can be detrimental for a startup as it threatens to eliminate the founders’ commitment and feeling of overall responsibility for the product or service to be developed.

• The stringent use of the “Four Eyes Principle” can also reduce the efficiency. The same applies to the tendency of many corporate investors to impose large catalogues of consent requirements on the founders. Interestingly, our experiences with U.S. startups show us that investors have recently scaled back on their control requirements in order not to overly curtail the startup’s agility and the founders’ willingness to take risks.
Advisory Board

When there are more than just a few shareholders, a delegation of general responsibilities from the shareholders’ meetings to an advisory board is advisable, as advisory boards will be able to pursue a more flexible and faster decision-making process for actions for which the founders require prior approval. When a multitude of founders exist, founders should coordinate and combine their rights and duties in a consortium agreement and thereby grant voting powers to a single founder.

Corresponding rules of procedure for the advisory board can ensure fast decision-making (for example, through virtual meetings to be convened at short notice, resolutions by circular procedure via emails, etc.). The corporate has to make sure that its own members have a say and do not have to adhere to long approval and voting procedures within the corporate’s hierarchy first.

For German startups, the advisory board should not be set up as an optional supervisory board, and the regulations of sec. 52 German Limited Liability Companies Act and sec. 108 German Stock Corporation Act should be excluded. Otherwise, a member appointed by the investor cannot be granted the right to veto, especially for significant transactions and measures. Furthermore, recently the appellate court of the State of Berlin (Kammergericht) ruled that provisions regarding the “if” and “how” of an advisory board need to be stated in the articles of association and not only, as previously assumed, in the Shareholders’ Agreement.

For strategic investments by larger CVC investors, the establishment of an institutionalized supervisory panel may be useful, especially if CVC specialists and relevant experts of different business units of the corporate investor can be assigned to help the startup define, develop and implement a business model over a larger period of time and help it scale. The panel can also be responsible for identifying potential applications of the startup’s products for the corporate and cooperation possibilities as early as possible and follow through on such opportunities.
Application of Group Policies

Naturally, the startup has to adhere to elementary compliance rules to limit reputational and other risks for the corporate. The corporate should, however, not treat the startup as a “normal” subsidiary. Rather, it should implement basic compliance rules to avoid sanctions imposed under antitrust and similar laws (if the corporate and the startup form an economic entity, a violation of antitrust rules may cause penalties of up to 10% of the group’s annual turnover).

Furthermore, the corporate should make sure that the founders adhere to competition, data privacy and tax laws, and that the managing directors attend to their duties set forth in sec. 43 German Limited Liabilities Act. Startups tend to violate such laws, since the founders are often inexperienced. In this respect, they should be briefed on these legal duties and possible consequences and, where needed, given access to the corporate’s in-house legal resources.

When advising the founders on these rules and responsibilities, the corporate should be mindful of not overburdening the founders and management with new information. Consider breaking up compliance calls into more manageable sessions.

It is also reasonable to establish a scalable reporting system that can be adjusted according to the development of the startup. We noticed that some corporate investors applied the same (rather excessive) reporting requirements some of their IVC peers have implemented, which leads, especially in the early phase, to the tying up of valuable management capacities.

If it is anticipated that at some point the startup will exit to the corporate, the corporate should reserve the right to implement its own policies and quality standards at a particular point in time (eventually step-by-step). This will allow for an easier integration of the startup at a later point of time, and the smoother integration of the startups’ products and services by the corporate after a successful takeover.
Antitrust Reform as an “Anti-Exit-Law”?  

The German government is planning to tighten merger control for companies in the digital economy. What is this all about?

According to German lawmakers, the current German merger control rules insufficiently capture certain transactions in the digital economy. In particular, the concern is that takeovers of innovative startups by large and established firms may escape government control under certain circumstances. An example is the acquisition of WhatsApp by Facebook in 2014. This deal, despite a record purchase price of EUR 19 billion, almost escaped scrutiny by the competition authorities in Europe. The European Commission was able to carry out a merger control review only because Facebook itself had requested such a review.

Under existing law, the German Federal Cartel Office must be notified of mergers when revenues of the parties participating in the transaction meet certain thresholds. This is typically not the case for young internet companies. The German legislature therefore plans to expand control to cases where the “transaction value” (i.e., the purchase price) is particularly high. In the future, notifications can be mandatory if transactions exceed a value of EUR 400 million, even if the target does not generate any or only insignificant revenue. In addition, the Federal Cartel Office may obtain additional powers to review certain online markets (i.e., with regard to the market power of search engines). These amendments are expected to become effective by mid-2017.

If the proposals of the German government are implemented as planned, then certain (high-value) exits in the startup sector will become subject to more stringent government control. For this reason, the law project has been described as an “Anti-Exit-Law” by representatives of the German startup scene. However, linking the application of merger control to the value of a transaction is not a new phenomenon. On the contrary, the United States, which is home to a vibrant startup scene, has always applied a “size-of-transaction” test to determine the scope of its merger control rules.

Questions can be directed to:

Dr. Till Steinvorth  
Partner, Antitrust  
tsteinvorth@orrick.com
4 Exit Scenarios

The partnership between the corporate and the founders is usually limited in time. If the corporate is not interested in a takeover, then the founders and the investors will pursue the same objective, i.e., to realize the value of the startup by an initial public offering or, more often, to receive the highest price possible in a trade sale. Unlike an IVC investor, however, the corporate may consider a takeover of the startup. Here, the interests of the founders and the corporate can conflict.

Considering an Exit

Corporate investors should be aware that founders worry before accepting CVC money that such an investment will reduce or limit their exit prospects. Founders fear that the startup may appear less interesting for potential purchasers, especially the corporate investors’ competitors, given the corporate investors’ deep insights into the startup. Founders are also concerned that their tie-up with CVC funding will significantly weaken their negotiation position, especially because at this stage of the company’s development, no regular payment of dividends by the startup can be expected.

The founders and the corporate should therefore openly discuss possible exit scenarios at the beginning of their cooperation and agree on the rules and distribution of the exit profit in the Shareholders’ Agreement.

If the corporate primarily pursues strategic objectives, it may have an interest in completely taking over the startup down the road. A potentially undesired entrance of third parties in the shareholder structure can be prevented by including a preemptive right in the articles of association, in addition to the usual restrictions regarding transferability of shares. Furthermore, the parties may agree on call options for the corporate, allowing it to gradually take over the startup, where the purchase price of the particular acquisition round increases when certain milestones are reached. Examples for milestones are a marketable prototype which meets certain specifications, pilot projects, or the achievement of sales targets. Whether the founders will receive a corresponding right to request the purchase of their shares from the corporate, i.e. have respective put options, is a matter of negotiation.

If the corporate does not have a preferential right to purchase the startup or does not want to make use of such right, the founders must be able to realize the value of their shares through a sale to a third party.
Drag-along rights should be agreed upon in order to provide the buyer with the option to acquire 100% of the startup. In this case, it is important to ensure that the startup remains “exit-able,” especially when it is strongly interwoven into the business of the corporate. Here, the corporate has to ensure a suitable carve-out of the startup so that it can be taken over by a third party and be run stand-alone after the transition period.

To enable a smooth exit and subsequent takeover of the startup by the investor, regulations addressing issues resulting from the matrimonial property regime applicable to one or more of the founders should be included in the Shareholders’ Agreement. In Germany, founders living in a statutory property regime of joint marital community of property (Zugewinngemeinschaft) should agree in a marriage contract that (a) the founder is not bound by sec. 1365 German Civil Code and (b) her share in the startup will not be part of the compensation if this property regime ends in any other way than by death of the spouse. In the case that the founder lives in a joint property community (Gütergemeinschaft), the share in the startup is to be declared as paraphernalia of the founder and subsequently filed with the marital property register. If the founder holds her share through her private holding corporation, then the aforesaid applies accordingly with respect to her shares in the private holding corporation.

If the founder is not able to meet the requirements of the preceding paragraph, then she should, at least, obtain the spouse’s written (and notary certified) declaration of consent regarding all possible future share transfers under the articles of association or the Shareholders’ Agreement.
Exit Scenarios and Taxation

From a tax perspective, there are several exit options. If the startup is a corporation, the seller will profit from extensive tax advantages in the case of a share-deal exit.

Often founders plan to reinvest future exit proceeds. Here, founders are often well advised to hold their shares in the startup through a personal holding corporation from the outset. Such personal holding corporations can also be created at a later stage, but that might trigger tax issues. A sale of startup shares through a personal holding corporation offers significant tax advantages for sale proceeds, which can be reinvested by the holding corporation.

As a holding corporation, the Unternehmergesellschaft (haftungsbeschränkt), the German version of a “GmbH light”, is a good option. It offers limited liability and can be founded with a starting capital of merely EUR 1.00.

In the second half of 2015, the German government retracted the threatened cancellation of tax advantages for sales of diversified holdings (<10%). Be warned, though, that the Federal Ministry of Finance has not abandoned the idea and may revisit this plan at a later date. If it should reemerge, CVC investors and founders should investigate whether they will be affected and then consider appropriate strategies to maintain tax privileges to the farthest extent.
T&C Control of Stock Option Plans

In Germany, the Employee Stock Option Plan (ESOP) and the underlying individual agreements with employees will regularly be subject to particular controls through courts under sec. 307 et seq. German Civil Code, as they are classified as standard business terms (Allgemeine Geschäftsbedingungen). Thus, the provisions must be formulated clearly and may not unreasonably disadvantage employees.

Eligible employees may not be chosen in a discriminatory manner or in breach of the German General Law on Equal Treatment. The latter is obvious, but even a general exclusion of part-time employees because of their reduced working hours would be unlawful. However, the consideration of only a particular hierarchical group may be justified.

Provisions on vesting and forfeiture are regularly in the focus of interest. Such agreements are not generally unlawful, but legitimate individual interests of the employee have to be taken into account on a case-by-case basis. German employment law has set clear boundaries. A total loss of options vested over many years due to voluntary resignation of the employee has been determined as invalid, even when the contract includes a “Bad Leaver” mechanism. This is due to the fact that the employee would otherwise be unreasonably limited in her occupational freedom and would lose the compensation she already earned.

Questions can be directed to:

Dr. André Zimmermann, LL.M.
Partner, Employment Law
azimmermann@orrick.com
5 Incentive Schemes and Compensation Issues

In classic IVC investments, the investment managers who are responsible for the success of the startup participate as "carry beneficiaries". This means they are rewarded monetarily for the success of the investments they are overseeing; often very handsomely if the startup is successful. Employees of a CVC investor may be in a similar important position for the CVC investments, but often without the built-in monetary incentives. CVC investors should consider appropriate structures to attract qualified internal and external candidates for their CVC activities and keep them on board. Similar considerations apply to employee compensation in the startup itself.

The Corporate’s Employees

Critics often reproach CVC investors because their employees have fewer incentives to go the “extra mile” for their startups than their peers at IVC investors. Investment managers at an IVC investor enjoy a monetary reward that is linked to the success of their startups (known as “carried interest” or “carry“). Corporate investors frequently lack comparable incentive structures. Accordingly, particularly engaged and skillful employees often leave the CVC unit of the corporate during the investment period, because they are promoted within the group or join an IVC investor instead. Savvy founders will be aware of this risk of losing an important “sponsor” within the corporate who is often the startup’s only point of contact to its investor. Empirical studies also show that a “corporate typical” compensation of CVC investment managers may lead to risk-averse investment behavior and, therefore, corporate investors often tend to invest in startups only at a later stage, foregoing the potentially huge upside of early stage investments.

IVC compensation systems are often incompatible with the remuneration agreements within larger companies. However, some corporate investors, such as Unilever with its CVC fund Physic Ventures, have adopted typical IVC structures to a large extent.

Other corporate investors have introduced a specific bonus system, which seeks to partially re-create economically the IVC investments’ carried interest.
Another way to address these incentive issues may be to give the responsible corporate managers the opportunity to invest into the startup alongside the corporate. Interestingly enough, some of the most successful IVCs in the United States (such as SV Angels or Lowercase Capital) are known for their managers investing as business angels together with "their" funds. GV (formerly known as “Google Ventures”) demonstrates that this may also be a solution for CVC investments since partner Mike Rose often invests in parallel with GV.

The Startup’s Employees

On their growth trajectory, startups require financing as well as qualified staff to support their growth. However, employees often cannot be offered attractive cash compensation. Employee participation programs play an important role in attracting and binding qualified personnel.

Compensation in the form of employees’ participation in startups can be an interesting option for founders as well as investors. A specifically structured ESOP can help align key employees' incentives towards a successful exit.

Direct, Indirect, and Virtual Shareholding

At first glance, granting an employee shares in the startup appears to be a straightforward solution. However, in case of a German GmbH, shares do come with certain unalienable rights. This creates the danger of particular decisions being challenged by employees and the decision-making process becoming too complicated. Due to these far-reaching information and control rights, as well as the costs of its implementation (notarization, administrative efforts, and drafts of extensive contractual arrangements), the transfer of real shares to employees is usually not a suitable option for German startups.

In indirect forms of shareholding, the employee receives shares via a special employee holding company that acts as intermediary. Besides saving notary costs, this model has the advantage for the founders and investors that the group of direct shareholders of the startup remains small. However, this solution still requires a certain amount of administrative effort and is only useful when a certain threshold number of shareholding employees is reached.

Virtual shareholding can solve the issues previously outlined by economically simulating the position of a shareholder without (from the startup's perspective) the disadvantages of actual shareholding. Models in this area, known as virtual stock options, stock appreciation rights, or phantom shares, typically embody the following structure: The employee will realize the economic value of her virtual shareholding only in case of a successful exit. Unfortunately, at that time the payments will be subject to income tax, and so virtual shares are less appealing from the employee's point of view. Other than usual employee benefit programs (such as profit-related bonuses and silent partnerships), virtual shares do not yield entitlements to annual profits. Rather, the exact amount of the value of the virtual shares depends on the proceeds generated from the exit. Unlike direct employee shares, virtual shares only offer minimal rights of information and control and no right to a say.
How Does a Virtual Stock Option Plan Work?

In the case of an exit, the virtual stock option plan entered into between the startup and the selected employees places the employees, from an economic point of view, in the same position as a common shareholder (except for the applicable tax regime). If the employee is granted a virtual holding of 5% in the share capital, then he will receive 5% of the purchase price a common shareholder will receive in the form of a payment claim against the startup.

The costs incurred by the shareholders and investors will usually be subtracted from the employees’ entitlement. This includes taxes, transaction and acquisition costs, and liquidation preferences for certain shareholders. The employee therefore does not gain a real share in the company but a virtual share in the increasing value of the business, the exact amount of which is determined by the purchase price in case of an exit. The individual’s contribution to the startup’s increase in value can be taken into account by “base price” provisions. Economically, base prices are deductibles from the employee’s payment entitlements under her virtual shares. In order to reflect that the first employees of a startup bear a higher risk and contribute more to the startup’s development, they will get a lower base price than later stage employees.

Virtual shares usually vest over time. When an employee leaves the startup without fault as a “good leaver”, then she will receive payment for her vested virtual shares at the time of the exit.

If the employee leaves the startup as a “bad leaver” (e.g., because her employment contract is terminated for cause), then the plan usually states that all virtual shares shall be forfeited or be compensated only against payment of the virtual shares’ nominal value.

Moreover, not all “German” virtual stock option plans are suitable for employees with tax liability in the United States. Some plans will need to be adapted in order to minimize material tax risks for such employees. Hence, it can be useful to use an “international” virtual stock option plan right from the start when it can be assumed that the startup will sooner or later hire employees in the United States.
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sgreulich@orrick.com

Orrick, Herrington & Sutcliffe LLP
Orrick-Haus
Heinrich-Heine-Allee 12
40213 Düsseldorf

Tel: +49 (0)211 36787-0
Mobile: +49 (0)175 2270012

Your contact in Munich

Dr. Thomas Schmid
tschmid@orrick.com

Orrick, Herrington & Sutcliffe LLP
Rosental 4
80331 München

Tel: +49 (0)89 383980-0
Mobile: +49 (0)151 12623802

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