VENTURE CAPITAL INVESTMENT IN THE NETHERLANDS: MARKET AND REGULATORY OVERVIEW

This Q&A gives a high level overview of the venture capital market in the Netherlands; tax incentives; fund structures; fund formation and regulation; investor protection; founder horizon, incentives for employees, and of course exits.

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1. Market Overview

What are the main characteristics of the venture capital market in The Netherlands?

1.1 Venture capital and private equity

The venture capital (VC) market is part of the private equity market. VC focuses on risk-bearing, mid-term investments in the equity of relatively small or medium-sized private companies. These companies usually undertake ventures requiring external investment in one of the following phases:

- ✓ Seed phase.
- ✓ Start-up phase and other early stage.
- ✓ Growth phase and other later stage.
- ✓ Expansion stage.
- ✓ Maturing stage.

These ventures usually have the following characteristics:

- ✓ High growth potential.
- ✓ Innovative business. New business or product development ventures in cooperation with an existing company (Corporate venturing).
- ✓ New business or product development ventures within the company itself.
- ✓ The inability to acquire sufficient bank financing, due to the venture's high risk profile, and the banks' risk-averse policies and securitisation requirements, including the Council Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), and the agreement reached by the Basel

Committee on Banking Supervision on the new bank capital and liquidity framework (Basel III).

VC is an important contributor to innovation, employment and growth, mainly looking at mid-term investments (such as a proper exit, initial public offering (IPO) or other divestment):

- ✓ Including some sort of contribution by the VC investor to venture management skills, knowledge and network and strategic expansion.
- ✓ Not expecting short-terms returns, but potential high-yield or strategic advantage.

1.2 Sources of funding

VC funding comes from all types of sources, such as equity, network and know-how contributions by:

- ✓ Venture capital firms.
- ✓ Regional development agencies.
- ✓ High net-worth individuals (HNWI).
- ✓ HNWI, organised in a consortium.
- ✓ Companies.
- ✓ VC funds of companies.
- ✓ Universities.
- ✓ Institutional investors.

1.3 Types of company

VC investors look to invest in ventures with specific characteristics (*see chapter 1.1, Venture capital and private equity*). These include companies in the following industries:

- ✓ Information technology and IT services.
- ✓ Media and Entertainment.
- ✓ Consumer products.
- ✓ Medical Devices, Healthcare, Biotechnology, and Life Sciences.
- ✓ Cleantech, Energy and Sustainability.
- ✓ Niche players in other, existing markets.

1.4 Market trends

Venture capital has enabled the support of entrepreneurial talent by turning ideas and state-of-the-art science into products and services. Venture capital funds build companies from the simplest form (perhaps just the entrepreneur and an idea expressed as a business plan) to freestanding, mature organisations.

The Netherlands has had a culture of supporting venture capital since the 1600s, by initiating and funding private and public ventures that operated worldwide, the first multinational corporation in the world was established, The Dutch East India Company. This venturing became the basis of the Dutch Golden Age in the 17th century. Nowadays, venture capital is capable to foster world leaders in business. Same as in other countries, as per the financial crisis, the past five years, venture capital and other private equity investments has been much less than the years before. However, the past years investment levels have increased with 50% per annum.

The estimated total amount of new available venture capital has almost doubled since 2012, for the following reasons:

- ✓ A number of major investments by foreign parties.
- ✓ There has been a stable market; the number of transactions reached a record level, but the average value per investment was down. VC investors have increased their focus on strengthening, supporting, increasing and securing value and growth of their existing ventures.
- ✓ Pension funds and VC funds have increasingly invested in VC the past years.

Since the financial crisis the total, Dutch VC funds manage about EUR29.8 billion per year. Also, almost 50% of the total investment amount came from outside The Netherlands, which indicates that VC investors from abroad are interested and active in investing in Dutch ventures. Interestingly, national and foreign investments in seed-phase ventures has increased much more than in other phases, and later phase ventures were able to secure much larger investments mainly coming from foreign VC Funds.

I where years of contrasts. Write-offs decreased amounting around 11% of the total divestments. Furthermore Dutch VC Funds have increasingly focused on seed funds and small transaction while foreign VC Funds supported the later stages with bigger transactions.

For the upcoming years, more fundraising and other VC activities are expected since supervision and regulation may provide some relief in the market, beside VC investors increase their focus on strengthening, supporting, increasing and securing value and growth of their ventures in the future.

1.5 Legal changes

Are there any recent or proposed regulatory changes affecting the venture capital industry?

Certain (recent) legislative changes may render the VC industry more efficient and attractive. For example, a new release of corporate legislation regarding the Private Limited Liability Company (B.V.) has become operative. Various mandatory regulations have either been abolished or eased, making the B.V. more flexible. Accordingly, the unofficial name for this legislation has become "Flexible B.V.". The new legislation applies to both new and existing B.V.s, though sometimes it will be necessary to adopt (in due time) the articles of association of an existing B.V. in order to be able to use the new law. Main features in the Flexible B.V. legislation are (but not limited to):

- ✓ The issued share capital must consist of at least one share with a nominal value of at least 1 Eurocent (EUR0.01) or a foreign currency (in the past, the issued share capital of a BV at least had to amount to EUR18,000).
- ✓ A blocking clause in the articles of association is no longer mandatory, and has become optional.
- ✓ It is now also possible to create shares without or with a limited voting-right and shares without or with a limited profit or reserves entitlement.
- ✓ Various former mandatory capital protection regulations have been eased (for example regarding (profit) distribution, purchase of own shares by the BV and the procedure of capital reduction) or abolished. On the other hand there is an aggravation of the liability of the directors in case of distribution by the BV (profit, reserves or otherwise). If after a distribution, which has been approved by the directors, the BV cannot pay its due and payable debts, the directors who at the time of the distribution knew or should have foreseen in reason will be severally liable towards the BV for the deficit arisen through the distribution, with the legal interest as of the day of distribution.

Another attractive legislative change is the introduction of the one-tier board, made available for both BV's and NV's. At a company with a one-tier board, the supervisors are no longer seated in a separate supervisory board but in the management board itself, as non-executive directors. The executive directors in the management board will be managing the company on the day-to-day basis. The most significant benefits of the choice between one-tier board and the current obligatory two-tier board are that:

- ✓ A one-tier system is easier to understand for international investors and stakeholders.
- ✓ The non-executive board members can communicate with the executive board members more efficiently, and vice versa. The information exchange improves as a result.
- ✓ The executives will find it easier approach and involve the non-executives in the decision making concerning major business matters.
- ✓ Remuneration of the executives will be determined by the non-executives.

However, certain forthcoming changes may make the life for VC more difficult, although this will also render VC much more transparent. For example, Directive on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2011/61/EU (AIFM Directive). The AIFM directive will affect the VC industry in a number of ways, for example:

- ✓ Financial transparency will be increased.
- ✓ The fund managers will be subject to more extensive reporting requirements and will have to refrain from any asset stripping during the first two years after a takeover.

2. Tax incentive schemes

What tax incentive schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

The following tax incentive schemes exist:

- **The Innovation Box.**

  The most significant benefits of the Innovations Box are that:

  ✓ The effective corporate income tax rate is 5%, instead of the usual rate of up to 25.5%;

  ✓ The innovation box is in principle not limited to income from self-developed patents, income from (non-patented) 'qualifying R&D-activities', may also be included in the innovation box. The R&D facility applies to intangible assets created as a result of R&D activities. It is normally easier to obtain an R&D certificate than a patent, which means that the lower rate will apply to R&D assets sooner than it will to patented assets.

  ✓ There is no maximum amount to which the tax benefit can apply; R&D expenses may be immediately deductible, i.e. in the year in which they are incurred. The level of profit attributable to IP depends on the importance and the level of the R&D activities within the company, as well as a.o. the number of patents, level of royalty income and level of the applicability of the R&D Facility.

  ✓ If the taxpayer is issued an R&D certificate for its R&D work used to achieve a payroll tax and social security remittance (monetary) reduction, the economic benefit attributable to the relevant intangible asset (the R&D asset) can be reported in the Innovations Box;

  ✓ The 5% rate will only apply to the proceeds from patents and qualifying R&D-activities after recovery of those losses and expenses at the regular tax rate. In practice it is required to conclude a ruling with the Dutch Tax Authorities on the amount of profit attributable to the Dutch Innovation Box.

  ✓ Losses incurred in relation to R&D activities are deductible at the regular rate of 25.5% (in excess of EUR200,000). However, the losses do raise the threshold that must be met before the lower corporate income tax rate will apply.

The explanatory notes to the Innovations Box confirm that software and certain business secrets fall within the scope of the Innovations Box.

Furthermore, The State Secretary of Finance has introduced guidelines as to which extent activities can be outsourced. According to the State Secretary, a company may still be eligible for the innovation box if the taxpayer has carried out more than 50% of the R&D activities itself or has supervised the outsourced R&D activities. In the case of supervising activities, it is essential that R&D certificates (as a result of the applicability of the R&D Facility (see below)) are obtained (at least in part) for the R&D supervising activities. Regarding these, a ruling as set above is typically required.

- **30% Ruling.** For highly qualified employees who come to work in the Netherlands on a temporary basis, the tax burden and the way of determining taxable income could create serious problems if the Netherlands did not have special regulations for such employees. Therefore, for a maximum period of eight years, so-called 30% rulings are available for qualifying individuals, who come to work in the Netherlands on a temporary basis. The first advantage of the 30% ruling is, broadly, that the employer may grant the employee a tax-free allowance equal to 30% of his gross employment income without having to prove that this is a reimbursement of extra-territorial costs (i.e. extra costs of temporarily staying outside the country of origin). Of course, there are certain terms and conditions to be met in order to be eligible for this ruling, such as for instance (without limitation):

  ✓ A minimum gross salary of EUR 36,378 (2014) is required (EUR 51,969 before reduction of the 30% allowance), except for employees under 30 with a Master degree (2014: EUR 27,653, respectively EUR 39,504) and scientists (no minimum). In general, scarcity of the employee's skills should (only) be demonstrated if the salary in (almost) the entire branch is higher than the above mentioned minimum salary.

- ✓ The employment contract will have to stipulate that the gross salary includes a 30% allowance as defined by law. As a result the employee will be taxed on approximately 70% of this employment income.

Another advantage of such ruling is the possibility for the employee to opt for a treatment as a partially non-resident taxpayer, which implies that the employee is only taxed as a resident for business and employment income; for income from substantial shareholdings and net wealth he can opt for taxation as a non-resident. School fees for primary and secondary international schools can be reimbursed by the employer on a tax-free basis.

- **Participation exemption.** The profit derived from an investment in a venture company by a Dutch corporate investor may, in certain circumstances, be exempt from Dutch corporate tax under the participation exemption (*see Chapter 4, Fund structuring*). A non-Dutch corporate investor in a Dutch company may, in certain circumstances, become subject to Dutch corporate tax. This may occur if both:

  - ✓ the investor is located in a country with which The Netherlands has not concluded a tax treaty; and

  - ✓ the non-Dutch investor does not carry on an active enterprise in the Netherlands to which its investment can be attributed.

- **Passive investments.** In addition, investments by Dutch individuals in ventures are generally considered to be passive investments that are deemed to have a fixed annual yield of 4%. This deemed profit is taxed at 30%. In certain circumstances, deemed income may be exempt from Dutch taxation at the level of the Dutch individual investor for qualifying investments of up to about EUR55,000 into start-up companies. This exemption may apply to an investment by a Dutch individual into a venture, as well as to a venture's qualifying investments.

In addition, investments by Dutch individuals in VC companies may also be taxed at 25%, where the investment is considered to be a substantial interest at the level of the Dutch individual. In essence, this taxation level may apply if the individual holds, directly or indirectly, 5% or more in the capital of the venture. This is why individuals often hold 4.99% in the capital of a venture, in order not to be taxed at 25% (but rather benefit from the 1.2% rate, based on a passive investment (*see above*)).

3. Funding sources

From what sources do venture capital funds typically receive funding?

Venture capital funds receive funding from various parties such as:

- ✓ Informal investors.
- ✓ Family-owned companies (which may have their own VC funds).
- ✓ Other HNWI.
- ✓ Universities.
- ✓ Development finance institutions and other government-initiated bodies.
- ✓ Institutional investors, such as banks, pension funds and insurance companies.

At present, bank financing is still rather rare (*see chapter 1.4, Market trends*); less than 15% of the total invested amount is funded by banks. However, there is an increase in VC activities, investments and exits. Also, the number of government subsidy schemes is still extensive. In any event, a VC investor that does not have its own, or other non-debt financing, will be unable to make investments in the current economic climate.

4. Fund structuring

Can the structure of the venture capital fund affect how investments are made?

The Netherlands remains a beneficial jurisdiction for establishing holding structures. One of the main benefits is the Dutch participation exemption, based on which profits from qualifying investments can be received tax free. In addition, The Netherlands is an appropriate jurisdiction to upstream profits from investments in jurisdictions with which European countries have not concluded tax treaties, given the extensive and favourable Dutch treaty network.

Although no specific corporate tax rules are in place in relation to investment in ventures, it is advisable to seek tailored professional advice (*see chapter 2, Tax considerations*).

To ensure that a VC fund is structured tax efficiently, the tax matters set out below should be considered at the outset.

4.1 Participation exemption

The participation exemption exempts profits derived from qualifying investments in other companies for corporate income tax purposes. Profits covered include:

- ✓ Cash and stock dividends.
- ✓ Bonus shares and hidden profit distributions.
- ✓ Capital gains realised on the disposal of the qualifying shareholding.

Capital losses are generally not deductible, although specific rules apply concerning liquidation losses of qualifying investments. Remunerations on qualifying hybrid loans are also often exempt under the participation exemption, provided the creditor also has a qualifying interest in the debtor.

In general, the participation exemption applies to investments of at least 5% in the share capital of an active company with a capital divided into shares. In certain circumstances, an interest of at least 5% in the voting rights also qualifies. An active company is a company that cannot be a low-taxed passive investment company, and has the following characteristics:

- ✓ More than 50% of its assets consist of non-business related investments.
- ✓ The profits are taxed at an effective rate of less than 10%.

There is no minimum holding period applicable to the participation exemption. Interest costs concerning the acquisition financing of the participation are tax deductible, if certain conditions are met. Acquisition and disposal costs in relation to the participation are non-deductible.

New rules concerning the participation exemption became effective. These have simplified the existing rules for determining whether a subsidiary should be considered a passive investment, in particular by introducing, as an alternative to the existing tests, a subjective condition that the shareholding be not held as a mere portfolio investment.

In addition, the application of the condition concerning an effective taxation of at least 10% has been simplified under the new rules. The other main provisions of the Dutch participation exemption remain unchanged.

4.2 Tax rule on excessive remuneration

A special tax rule on excessive remuneration is in place. In essence, it provides that the proceeds derived from the investment or other lucrative interest may be taxed at regular progressive rates of up to 52%, where those are considered to be related, directly or indirectly, to the working relationship of the individual and the company, or a group company, in which the investment or interest is being held (carried interest).

4.3 Dutch withholding taxes

The Netherlands does not levy withholding taxes on interest payments (except in the case of qualifying hybrid loans) or royalty payments. In addition, no withholding taxes apply to management fees. Dividend payments are, in principle, subject to dividend withholding tax at the regular rate of 15%, but this is often reduced partly or totally on the basis of tax treaties or EC directives. The legal entity known as the co-operative is not subject to dividend withholding tax and as such is often used in holding structures (see chapter 4.6 Dutch Ruling practice/transfer pricing).

4.4 Value added tax

The standard value added tax (VAT) rate is 21%. VAT, the main indirect tax, is levied on the net invoice price charged by a business for the supply of goods and services within The Netherlands. VAT is also levied on the intra-EU acquisition of goods and on goods imported into The Netherlands.

The general principle is that the VAT paid by a business to its suppliers (input VAT) can be offset against the VAT it charges to its customers (output VAT). The net amount of VAT is then remitted to, or recovered from, the tax authorities.

4.5 Payroll tax and social security contributions

Employment income includes all employment income, such as wages, salaries, pensions, share options, benefits in kind and so on. This income is generally subject to payroll tax. Payroll tax is normally credited when determining the final income tax liability, or refunded. Social security and welfare payments are also generally subject to payroll tax.

Certain employees coming to work in The Netherlands may be paid a tax-free allowance, under a provision known as the 30% ruling, equal to 30% of their salary. This facility is subject to various conditions including being able to show that the employee possesses special expertise, which is either not available or is scarce in the Dutch labour market.

4.6 Dutch ruling practice/transfer pricing

The advance tax ruling (ATR) system is a centralised, efficient and transparent procedure. It is a flexible, tailor-made system, in line with international standards. ATRs may be concluded in relation to holding structures using co-operatives.

Taxpayers that want to obtain advance comfort concerning their transfer pricing can apply for an advance pricing agreement (APA). This may be in a unilateral, bilateral or multilateral form, and is regulated by detailed procedural regulations. Special rules apply for group financing and licensing arrangements. Pre-filing meetings may also be requested to help further streamline the process.

Do venture capital funds typically invest with other funds?

VC investors can jointly invest in a venture, for example by co-investing with other investors, or through a VC fund or consortium. This is usually done to:

- ✓ Add more financial backbone, know-how and value to the venture.
- ✓ Mitigate risks.
- ✓ Increase the possibility of a higher return.

What legal structure(s) are most commonly used as vehicles for venture capital funds in your jurisdiction?

VC investors mainly use a combination of the following entities:

- ✓ BV.
- ✓ NV.
- ✓ CV.
- ✓ Co-operative society, although this is significantly less attractive as per new tax arrangements on trying to restrict unreasonable tax-advantages.

- ✓ Mutual fund (fund for joint accounts).

If an investment company is a legal entity (either an NV or BV), it is governed by the Dutch Civil Code (DCC), containing provisions concerning, among others, control, distributions and capital.

An investment fund does not qualify as a legal entity and therefore these provisions of the DCC do not apply.

5. Investment objectives

What are the most common investment objectives of venture capital funds?

VC focuses on risk-bearing, mid-term investments in the equity of private companies. On average, a VC investment period lasts about five years, although this is subject to economic, internal and market issues, among other things.

If stakeholders intend to arrange an exit in, for example, three or five years, in practice an actual exit will occur in at least six or eight years, respectively. VC funds and other VC investors should take this into account when investing. The exit period will, however, depend on the market the venture is active in, and should be assessed on a case-by-case basis.

6. Fund regulation and licensing

Do a venture capital fund's promoter, manager and principals require licences?

In certain circumstances a licence is required. For example, the management company or VC fund requires a licence, issued by the Authority for the Financial Markets (AFM) under the Act on Financial Supervision (AFS), if it wants to offer a right to participate in a VC fund in The Netherlands (this does not apply to a VC company). A VC fund must also have a separate management company and a custodian.

No licence is required if a VC fund or company is incorporated and governed by the laws of an EU member state and already holds a European passport.

Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

A licence is required to offer rights to participate in a VC fund in The Netherlands (see chapter 4.6 Dutch ruling practice/transfer pricing) unless one of the following AFS exemptions applies:

- ✓ The right to participate is only offered to qualified investors.
- ✓ The offer is extended to fewer than 100 persons, not being qualified investors.
- ✓ The units being offered have an individual denomination of at least EUR100,000.
- ✓ A participant can only acquire the units being offered for a total consideration of at least EUR100,000.
- ✓ The participation offered is in a fund subject to a special scheme for providing seed capital to technology start-ups.
- ✓ The units offered are in a collective investment scheme that fulfils the requirements set by the Minister of Finance concerning the supervision of collective investment schemes (that is, the scheme provides sufficient safeguards in relation to the interests that the AFS seeks to protect).

If any of the above exemptions apply, the VC fund must inform the public when making its offer to participate, as well as in marketing and advertising statements, that it does not hold a licence and is not supervised by the AFM. The exact content of the statement depends on whether the VC fund is open or closed-ended, and the party offering the units. When marketing a VC fund or a venture, a prospectus, such as an information memorandum, is required.

In addition to the licensing requirement, AFM approval of the prospectus is required, provided that similar exemptions as set out above do not apply. This AFM approval requirement does not apply to open-ended funds, or closed-ended funds that do not have transferable participation rights. There is also no AFM approval requirement if the relevant VC fund is incorporated under the laws of an EU member state, and has already met the relevant prospectus obligation in its country of incorporation.

How is the relationship between investor and fund governed? What protections do investors in the fund typically seek?

Each VC fund, structure and VC investor is different. However, most investors and funds seek to have their relationship governed and protected by the following documents:

- ✓ Prospectus.
- ✓ Partnership agreement.
- ✓ Investment agreement.
- ✓ Articles of association.
- ✓ Shareholders' agreement.

In addition, investors and funds usually seek to determine the:

- ✓ Purpose of the fund.
- ✓ Planning and timing.
- ✓ Duration of the fund.
- ✓ Limitation of liability.
- ✓ Corporate governance (such as veto and majority rights).
- ✓ Investment committee/advisory committee.

- ✓ Distribution of investment proceeds on divestment.
- ✓ Management compensation.
- ✓ Profit sharing arrangements.
- ✓ Clawback arrangements.
- ✓ Restrictive covenants, such as:
  - ➢ change of control;
  - ➢ restrictions on the fund manager preventing it from managing another fund until the relevant fund is invested up to an appropriate level;
  - ➢ non-compete;
  - ➢ trigger events granting the right to replace a manager.

Where the VC fund has a prospectus (either mandatorily or voluntarily), the prospectus should demonstrate how the above issues are being managed, or at least how they are proposed to be managed.

7. Interests in investee companies

What form of interest do venture capital funds take in an investee company?

VC focuses on risk-bearing investments in equity (*see chapter 1.1, Venture capital and private equity*). Equity contributions are therefore common, where a cash investment in a private company is made in exchange for shares.

However, in some cases other types of contributions can be made, such as:

- ✓ Contributions in kind, for example, by being the launching customer or preferred supplier.

- ✓ Providing equitable debt, most of the timing being (subordinated) convertible loans, which are converted into shares on an upcoming financing round, an exit or other event.

These investments are often provided in a combined form, depending on the wishes and needs of the venture, and the wishes and options of the VC investor and other stakeholders.

7.1 Tax considerations

Equity and debt investments should be carefully structured from a corporate tax perspective. Various detailed rules apply in relation to the potential denial of interest deduction on related-party loans. In addition, The Netherlands has thin capitalisation rules in place, which may deny interest deductions on related-party loans.

Remuneration on equity funding such as dividends and interest on qualifying hybrid loans are not deductible for corporate tax purposes.

8. Valuing and investigating investee companies

How do venture capital funds value an investee company?

Valuing a private company with a relatively short history is extremely difficult, whether the company is in the seed-up phase, start-up phase, other early-stage phase, or maturing phase. It is also difficult to value a public company or a private company with a long track record.

While each case is different, valuations are made by reference to the following factors:

- ✓ Management and key personnel. Competence, experience, commitment and company ethos are all important.
- ✓ Business plan.
- ✓ Analyses of business, product and services.
- ✓ Market conditions.

- ✓ Competitors.
- ✓ Cash needs and financial planning.
- ✓ Exit strategy and planning.

VC investors are usually conservative when valuing ventures, and in the current economic climate, valuations are even lower.

To the extent possible, VC investors make use of, for example, external valuation professionals, comparable companies or valuation mechanisms such as discounted cash flow valuation, or a combination of these, to determine the investee company's value.

On the basis of the investee company's valuation and other factors, such as the desired internal rate of revenue (IRR), the VC investor will calculate what it is willing to contribute, when and in how many tranches, and under what conditions.

What investigations do venture capital funds carry out on potential investee companies?

VC investors must thoroughly analyse and assess the venture and business, bearing in mind certain important factors. Due diligence is strongly advisable in relation to the following issues:

- ✓ The business itself.
- ✓ Intellectual property rights (IPR).
- ✓ Financials.
- ✓ Tax.
- ✓ Technical (such as electronic data process (EDP), auditing of software or other information and communication technologies).
- ✓ Legal.

- ✓ Human resources (HR) (including, without limitation, interviews with important members of the venture's organisation, which should not only be management, and reference checks).

In recent years, thorough IPR and technical due diligence has become increasingly important.

Traditional professional services providers often focus only on risks, threats and weaknesses when undertaking due diligence. However, a due diligence exercise is also a good moment to assess opportunities and an agenda for future actions and improvements related, for example, to tax, IPR, information and communications technology (ICT), legal or HR issues.

In addition, due diligence should not be limited to the venture itself, but should also cover the market, competitors, references and other stakeholders.

9. Legal documentation

What are the principal legal documents used in a venture capital transaction?

While each venture, structure, VC investor and investment is different, the following documents are usually used in a transaction:

- ✓ Teaser, that is, a brief non-binding information memorandum.
- ✓ Non-disclosure agreement.
- ✓ Information memorandum or prospectus.
- ✓ Term sheet or letter of intent.
- ✓ Approval of VC investor's investment committee.
- ✓ Investment agreement or subscription agreement.
- ✓ (Convertible) bridge loan agreement.

- ✓ Shareholders' agreement.
- ✓ Articles of association, or deed of amendment to it.
- ✓ Management and employment agreements.
- ✓ Employee option plan (on shares, depository receipts on shares, or otherwise).
- ✓ Post-closing action lists and other execution documentation.

10. Protection of the fund as investor

10.1 Contractual protections

What form of contractual protection does an investor receive on its investment in a company?

It is important that both the VC investor and the venture take care of their own interests as well as their mutual interest. They should determine and acknowledge:

- ✓ The extent to which the venture, the VC investor and the other stakeholders participate in the project together and for how long they intend to be involved.
- ✓ The comfort that each party needs to have to enter into the venture partnership.

In any event, it is advisable to have a clear and well-written investment agreement and shareholders' agreement, and to harmonise the articles of association with those documents.

The articles of association are a corporate law document, and as such prevails over other arrangements between the parties, such as the investment agreement and the shareholders' agreement. However, if one party breaches the investment agreement or shareholders' agreement, the other parties can sue that party for the breach and its related consequences, even if that party's action does not breach the articles of association.

Legal advice is required to assist the VC investor and venture in the drafting of the documents for the investment, including harmonisation of the articles of association with the other documents. For example, it is not always advisable to incorporate too many specific arrangements agreed on in a shareholders' agreement in the articles of association. This is not always permitted by law, nor is it advisable as the articles of association are available to the public through the Trade Register.

Contractual protection depends on the drafting and content of the relevant agreements, such as, for example:

- ✓ Clear and well-defined clauses.
- ✓ Proper execution of the agreement.
- ✓ Contractual ranking between the articles of association and shareholders' agreement.
- ✓ Explicit obligations, combined with certain penalty arrangements, such as:
  - ➢ financial penalties in the case of breach;
  - ➢ lapse of certain rights in the case of breach;
  - ➢ obligation to offer and sell certain equity in the case of breach.

10.2 Forms of equity interest

What form of equity interest does a fund commonly take?

The form of equity a VC investor is offered depends on the kind of investment and the legal specifics of the venture. Common options include:

- ✓ The VC investor is accommodated within the existing legal structure and shares of the venture, and such shares are issued to the VC investor in proportion to its investment.
- ✓ The existing legal structure and shares of the venture are amended to conform to the company's new investment status and the requirements of the VC investor. For example, various classes of shares (such as cumulative preferred shares or letter shares) can be created, so that (for example) certain preferences are available.

- ✓ New legal vehicles are incorporated to, for example:
  - ➢ restructure and update the whole group structure;
  - ➢ incorporate certain foundations to administer certain shares. This can, for example, be used to provide option rights over depository receipts on the shares to management and key personnel.

10.3 Preferred shares

What rights does a fund have in its capacity as a holder of preferred shares?

Preferred shares give the VC investor separate rights, and ensure that the other parties have separate obligations. These rights can be on issues such as:

- ✓ **Governance.** Certain resolutions of the company or management, the supervisory board or the shareholders meeting must be pre-approved by the preferred shareholders (for example, by a special majority of preferred shareholders). Sometimes, certain rights to veto a resolution are included. The preferred shareholder can nominate their own director(s) or supervisory board member(s), and the other shareholders must vote accordingly.

- ✓ **Information rights.** Depending on whether a supervisory board is in place, a VC investor will want to be able to access certain information on the venture, for example, updated profit and loss accounts, balance sheet, cash flow and other forecasts, on a monthly or quarterly basis.

- ✓ **Voting rights.** A VC investor may require the right to obtain more than the usual one vote per share, by converting the preferred shares into common shares at a ratio greater than one.

- ✓ **Anti-dilution.** Anti-dilution protection entitles a particular shareholder to maintain its fully diluted percentage of equity, for example if a subsequent issuance is at a lower price per share than that paid by that shareholder. Examples are (weighted) anti-dilution or full-ratchet clauses, although full-ratchet clauses are currently rarely used. For stakeholders other than that particular shareholder, it is important to at least time-limit these clauses.

- ✓ **Conversion rights.** A VC must be able to convert its preferred shares into common shares, for example, if a preferred shareholder would otherwise not share in financial proceeds. An example is a clause on automatic conversion in the case of an IPO.

- ✓ **Pre-emptive rights and right of first refusal.** These rights are the basic rights available to a shareholder in a private company such as a BV (*see chapter 10.4, Management control*).

- ✓ **Lock-up.** Shareholders might agree on a certain arrangement in which particular (or all) shareholders are not entitled to sell equity for a certain period of time. This is used, for example, to retain the commitment of the shareholder, and to ensure sufficient focus on the future.

- ✓ **Liquidation preferences.** If any dividend or other financial proceeds are available to the shareholders' meeting, the preferred shareholders may have the right to receive a certain part or whole principal amount first, after which the other shareholders are entitled to the remainder. In the case of cumulative preferred shares, an amount of interest agreed on accrues to the principal, until the interest or principal can be distributed to the preferred shareholder. Over the past decade, the VC market has seen liquidation preferences exceeding significantly the original contribution made by the VC investor (excluding interest), but these are no longer seen very often.

- ✓ **Good leaver or bad leaver.** A VC investor may require the incorporation of leave provisions in contractual arrangements, in which it is agreed that certain persons or entities selling their shares must offer them for a certain price to the other shareholders first (*see chapter 12.1, Incentives*).

- ✓ **Drag-along or tag-along.** A drag-along usually is the right of a certain majority of shareholders who are willing to accept a particular transaction with a third party (such as a 100% trade sale) to oblige the other shareholders to offer all their shares to that third party at the same price and on the same conditions as the majority of shareholders. In some cases, a matching right is incorporated in a drag-along clause, entitling the offering shareholder to match the third party's offer within a certain period. A tag-along typically is the right for a shareholder to proportionally offer its shares to a party at the same price and on the same conditions as another shareholder is offered at that time.

- ✓ **Divestment.** As the exit event is vital for a VC investor, it may require certain rights giving it control over the divestment process and the choice of a bank or corporate finance adviser.

10.4 Management control

What rights are commonly used to give a fund a level of management control over the activities of an investee company?

A VC investor wants to be certain about, for example, the execution of the strategic and business plan by the venture, and whether the venture spends its contribution wisely and in accordance with agreements made with the VC investor.

In addition to the general rights and obligations set out in the applicable law and articles of association, the VC investor will have certain additional control over the governance of the venture, at both the management and supervisory board level (under the traditional two-tier board system, as well the one-tier board system available) *(see chapter, 10.3 Preferred Shares).*

10.5 Share transfer restrictions

What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

Since 2013, a restriction on the transfer of shares (blocking clause) in the articles of association of a BV is no longer mandatory, but optional. This new Dutch law describes only one type of restriction on the transfer of shares:

- ✓ **The right of first refusal.** Under this restriction, a shareholder should first offer the shares that he intends to sell to the intended buyer to his co-shareholders, on the same terms and conditions.

- ✓ **Prior approval.** New Dutch law also gives the opportunity to choose an alternative type of restriction on the transfer of shares. Former Dutch law described that a body of the BV, as appointed in the articles of association, must grant its prior approval for the intended transfer of shares. This body is usually the general meeting of shareholders, but can also be the board of directors, the supervisory board or the meeting of holders of shares of a certain class.

As a restriction of your own choice is now allowed, the restriction by prior approval can still be used. Sometimes a combination of both the right of first refusal and the right of prior approval is inserted in the articles of association.

Shareholder agreements often contain the same provisions or an extended and more specific arrangement, based on provisions contained in the articles of association.

In relation to the NV, a restriction on the transfer of registered shares is also optional. However, if a restriction on the transfer of shares is chosen, one has to choose from a right of first refusal, a right of prior approval or a combination of both.

Also, it will be possible to include in the articles of association of a BV a prohibition to transfer shares until a certain time.

What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company?

Drag-along and tag-along rights, as well as certain similar rights, are often advisable and agreed on *(see chapter 10.3, Preferred shares).*

Other arrangements that can be incorporated in contractual agreements are:

- ✓ Put option, giving the VC investor the right to sell a specific quantity of equity at an agreed price.
- ✓ Call option, giving the VC investor the right to buy a specific quantity of equity at an agreed price.

10.6 Pre-emption rights

Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

Investors usually require such pre-emption rights. Dutch law grants BV and NV shareholders pre-emption rights on a pro rata basis. However, these pre-emption rights can be excluded on a case-by-case basis by resolution of the general meeting of shareholders. Exclusion in the articles of association is also possible, but not common.

10.7 Consents

What consents are required to approve the investment documentation?

To approve investment documentation, approval of the following direct stakeholders in an investment is required:

- ✓ The venture.
- ✓ The existing shareholders of the venture company.
- ✓ General meeting of the venture.
- ✓ The VC investor.

Other stakeholders may need to approve or advise on the investment, such as:

- ✓ The supervisory board of the venture.
- ✓ The supervisory board of the VC investor.

- ✓ The investment committee of the VC investor.
- ✓ The works council of the venture (*Works Council Act*).

11. Costs

Who covers the costs of the venture capital funds?

Each party usually bears its own costs, except for certain contractual cost arrangements. Such contractual costs may include a certain maximum amount of the cost of drafting certain documents such as the investment agreement, shareholders' agreement, (amendment of) the articles of association, or the notarial transaction costs.

To avoid discussions on costs, parties should clearly state who is responsible for the specific (and sometimes considerable) costs, such as corporate finance or other broker fees that may have been incurred.

12. Founder and employee incentivisation

In what ways are founders and employees incentivised? What are the resulting tax considerations?

12.1 Incentives

As each venture is different, incentives for founders, management and (key) employees differ on a case-by-case basis. There may also be differences in incentive arrangements between, for example, founders and other management or employees. However, the following are generally offered or considered:

- ✓ Salary arrangements.
- ✓ Annual, medium-term and/or exit bonus arrangements.
- ✓ Option pool, with a share or depository receipt option plan.

- ✓ Other tailored call option or other equity arrangements.

12.2 Tax considerations

See chapter 4, Fund structuring

What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture?

Each venture is different and there may be divergences concerning commitment arrangements between, for example, founders and other management members or employees. However, the following written clauses are usually agreed on:

- ✓ Additional investment.
- ✓ Lock-up.
- ✓ Clawback.
- ✓ Good leaver/bad leaver.
- ✓ Assignment of IPRs.
- ✓ Non-competition.
- ✓ Non-solicitation.
- ✓ Non-disclosure.

13. Exit strategies

What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

If the venture is not successful, certain exit scenarios may be considered, including:

- ✓ **Asset sale.** This involves the sale by the venture of (part of) its assets, followed by a dividend payment to the extent allowed, and finally a liquidation or share transfer.
- ✓ **Partial (trade) sale.** This entails the sale of a certain part of the shares in the venture to management or to a third party.
- ✓ **Liquidation.** This process is governed by the DCC and used to terminate the entire business of the venture. Normally it is the last resort before bankruptcy.

What forms of exit are typically used to realise a venture capital fund's investment in a successful company? What are the relative advantages and disadvantages of each?

Exit scenarios for a successful venture include:

- ✓ Trade sale of (all) shares to another (strategic or other) party.
- ✓ Initial public offering (IPO).

Typically, when considering exit scenarios, a trade sale transaction is considered more advantageous and is the starting point. For example, a trade sale may generate a higher return on investment with less risk than an IPO. However, if a trade sale appears not feasible, an IPO may be conducted. One of the disadvantages of an IPO is that its preparation (as well as keeping shares quoted on the stock market) requires both:

- ✓ Implementation of a substantial amount of financial, corporate and administrational changes in the organisation of the venture.
- ✓ Extensive formalities and approvals from the relevant authorities.

How can this exit strategy be built into the investment?

As failing to plan is planning to fail, it is important (and common practice in the VC market) for a VC investor, together with the stakeholders in the venture, to set out a clear strategy for a successful exit, including various arrangements to meet the set goals.

14. Contact details

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