

High growth companies and how to fund them – a real driver of economic growth?

Corporate Acquisitions and Joint Ventures Commission

Prague, 2014 – Working Session 04

National Report of Switzerland

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28 February 2014

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The working session in Prague is entitled “*High-growth companies and how to fund them – a real driver of economic growth?*” In the working session we plan to address funding alternatives for high-growth companies (i.e. companies with significant annual growth over time); opportunities and challenges that both entrepreneurs and investors may encounter in your jurisdiction. The working session will also look at corporate governance issues in connection with investments in high-growth companies. This questionnaire mainly concentrates on these two topics in relation to high-growth companies, but will also cover commercial and regulatory opportunities and constraints.

1.1 Which financial instruments are typically used when investing in high growth companies; ordinary shares, preference shares, convertibles, warrants, stock options, debt instruments such as bonds, hybrid instruments such as participating debentures etc.?

The type of financial instrument usually depends on the financing stage. While the issuance of ordinary shares and/or convertible loans generally dominate in seed financing phases, the issuance of ordinary and/or preference shares is typical for early stage financings. Once the venture has reached a certain scope (financially, businesswise or otherwise), the issuance of preference shares is clearly the main instrument used, especially in later stage investments. Stock options are mainly used for the purposes of incentive plans and less for financial investments while bonds or participating debentures are virtually non-existent in the Swiss venture capital scene, not least due to negative tax consequences.

1.2 Please elaborate on the pros and cons of the instruments used (ref. 1.1 above) (Describe 2-3 most widely used instruments more in-depth (any combinations as well, if applicable). Also other features, i.e. typically electronically registered instruments or not? etc.)

The issuance of ordinary shares is usually beneficial from a founder's perspective because it leaves the founders with more control over the company and with more financial upside as opposed to preference shares because preference shares typically provide for dividend and liquidation preferences. In addition, holders of preference shares typically have more "say" in the company (e.g. by requiring veto rights, board representation etc.).

Ordinary (or preference) shares dilute the founders' right from the beginning, thus making convertible loans more attractive for an initial phase. Convertible loans also have the advantage that no valuation must be made at the time of the investment (because the conversion typically takes place in connection with and on the basis of the next equity financing round).

1.3 Are there any regulatory constraints to the instruments used (ref. 1.1 above)?

No.

1.4 Is crowdfunding a funding alternative in your jurisdiction? How wide is the practice? If at all, please describe pros and cons.

Crowdfunding has gained some momentum recently in Switzerland. There has been a growing number of platforms most of which are purely "reward-based". Platforms which issue stock or debt to the crowd are not yet visible in the market. It should generally be noted that the crowdfunding market in Switzerland is

overall considered rather small thus making business cases for crowdfunding platforms less viable.

2. INVESTORS VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL

2.1 Who are typical investors into a high growth company in your jurisdiction? Sources of funding (i.e. founders-family-friends, angel investments, venture capital investments, private equity)

On the Swiss venture market all the commonly known types of investors are active (founders-family-friends, business angels, venture capitalists, private equity investors).

However, depending on the development stage of a venture and, based thereon, the financing phase and needs of such venture, the mainly active types of investors may vary considerably.

In the very early phase of the cycle (invention phase) financing (if at all existing) is limited to the founders themselves as well as family members and friends. Business angels or angel financing is probably the most frequent financing type for the seed financing phase. Only in the early stage and, in particular, later stage financing phase venture capitals and private equity firms (national and international ones) come into play and dominate the scene.

2.2 Is there a typical size of the investment into a high growth company in your jurisdiction?

In general, the amounts invested in Swiss high growth companies are rather low (if compared to international standards). A typical investment lies in the range of a couple of millions of Swiss francs and only rarely exceeds 20 million Swiss francs.

2.3 Describe the process of documenting the investment (Which documents are typical? Which terms need to be included in the articles to be enforceable? etc.)

An investment in a Swiss high growth company is generally based on the following documents:

- Letter of Intent (LoI): LoIs are in some cases seen and are used mainly as a means to find an agreement between the principals on the commercial outline of the investment (including points such as the investment range, the transaction structure and the timing) in an efficient manner, i.e., without getting caught up in the details. As the binding effect of a LoI is not clear, the LoI should in any event clearly specify which clauses are binding.
- Term Sheet: Term sheets are often used to summarize the principal terms of a potential investment. They are for discussion purposes only, and, except as

specifically set forth in the term sheet, not considered to contain legally binding obligations on the part of any negotiating party.

- **Investment Agreement:** The investment agreement, as one of the core documents, contains the fundamental provisions relating to the investment, such as the details about the investors, the investment amount, the envisaged capital and ownership structure (need for capital increase) of the target company (including valuation questions), representations and warranties given by the founders/sellers as well as jurisdiction and governing law clauses.
- **Shareholders' Agreement:** The shareholders' agreement is clearly the second core document of an investment into a high growth company. In addition to the provisions in the investment agreement it contains more detailed rules relating to the composition of the board of directors of the venture (including quorum of attendance at meetings, casting votes, signing authorities etc.), important shareholder and board matters, which require a qualified majority to be approved or where veto rights shall be introduced, information, rights, preferential rights (preferred dividend, liquidation of subscription rights (anti-dilution protection)), exit preferences, transfer restrictions (including rights of first refusal, pre-emption rights, tag-along/drag-along and good leaver/bad leaver provisions).
- **Articles of Incorporation:** the articles of incorporation of a Swiss growth company (if organised as a limited liability company (GmbH/Sàrl) or as a stock corporation (AG/SA/Ltd) (see also Section 3.1) include the basic corporate information and rules of a Swiss entity, such as its name, registered office, corporate purpose, the share capital, the number of issued shares (including their nominal value), the types of issued shares (ordinary and/or preference shares) as well as provisions relating to the shareholders' meeting, the board of directors and the audit/auditor. It is noteworthy that from a Swiss law perspective, share transfer restrictions (in case the company is organised as a stock corporation) can only to a very limited extent be included into the articles of association. Therefore, such restrictions are generally agreed on a contractual basis, i.e. in the shareholders' agreement.
- **Employment Agreements:** Often, investors request the founders to remain employees of the venture (know-how transfer) and ask them to enter into comprehensive employment agreements containing, *inter alia*, post termination non-compete obligations of the founders/employees.
- In a later stage financing phase, employee participation plans may become relevant, allowing the key employees to participate in the venture.

2.4 Are there incentive schemes for investing into high growth companies (governmental grants (including co-investment funds, state as a guarantor of loans, etc.)?)

We are not aware of any state funded incentive schemes for investing in high growth companies in Switzerland.

However, there are several private initiatives to promote private equity and corporate finance activities in Switzerland and to provide networking platforms to persons and companies interested in investing in such companies, such as e.g.:

Swiss Private Equity & Corporate Finance Association (SECA) (www.seca.ch), "the representative body for Switzerland's private equity, venture capital and corporate finance industries".

CTI Invest (www.cti-invest.ch), a private non-profit organization, serves as one of the leading financing and networking platforms for high growth companies, effectively complementing the start-up promotion program at the state-owned CTI (www.kti.admin.ch).

2.5 Any instruments referred to in section 1 preferred from the point of view of an investor? Why? Would the answer differ if the investor is international or domestic?

As mentioned in Section 1 above, the type of financial instrument preferred for an investment in a high growth company depends to a larger extent on the financing phase of the venture, rather than the investor. Obviously, the degree of complexity increases with the development of the venture.

From a Swiss perspective this is true for Swiss and foreign investors.

It is noteworthy in that respect that based on the principle of economic freedom, as guaranteed in the Federal Constitution of Switzerland, the Swiss economic and legal framework is very liberal with regard to inbound investments. In particular, there is no general restriction or authorization requirement neither for such transactions nor for inbound or outbound payments.

To the extent that based on industry-specific restrictions an authorization is required (e.g. for industries such as banking, securities dealing, insurance operations, investment funds, casinos and gaming, air transport, media and telecommunication, etc.) or an change of ownership must be notified to the authorities, the Swiss regime does not, subject to very few exceptions, make a difference between Swiss and foreign investors. A special regime solely applies to the direct or indirect acquisition of Swiss real estate by foreigners.

3. ENTREPRENEUR'S VIEWPOINT – OPPORTUNITIES AND CONSTRAINTS, LEGAL AND COMMERCIAL
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3.1 Which company form is most popular? (Special company forms for high growth companies? Tiers of management typical for a high growth company? Liability point of view?)

Many founders start off with a limited liability company (GmbH/Sàrl) and they sometimes keep this form throughout their seed financings and sometimes even through early stage financing rounds. However, for a number of reasons the stock corporation (AG/SA/Ltd) is more suitable for high-growth companies and in fact, most such companies are structured as a stock corporation. In a stock corporation the management is typically organised by having a board of directors (with the founders and some representatives of the investors which are, however, non-executive) and a separate management board (with the founders and possibly additional key employees).

3.2 What sectors are most preferred by high growth companies in your jurisdiction (information and communications technologies, biotech, etc.)?

Switzerland traditionally has a high output of growth companies in the life sciences sector (biotech and medtech), especially measured by the invested capital. In 2013, CHF 276 million have been invested in this sector, followed by the ICT sector with a total of CHF 124 million. Cleantech has seen a sharp rise in 2013 by seizing a total of CHF 30 million.

3.3 Are there incentive schemes for entrepreneurs incentivising high growth companies (e.g. accelerators/incubators? Other?)

Throughout the country there are various incubators targeted at high growth companies, especially in the region of Zurich, Basel and Lausanne. There is currently talk about a possible accelerator being set-up in Zurich but it is unconfirmed.

In addition, a large number of competitions incentivise high growth companies as do various coaching programmes (including some led by the government such as the CTI Start-up Programme, see also Section 2.4 above). In 2013, start-ups with a CTI Start-up label received more than CHF 100 million of investments.

Finally, financing by business angels, universities and technical schools is generally a well-established source of funding, especially in the early stage area. Some banks have also started to grant financings to start-ups.

3.4 Any instruments referred to in section 1 preferred from the point of view of an entrepreneur? Why?

As mentioned above, an entrepreneur would typically prefer investors to subscribe for ordinary shares.

4. CORPORATE GOVERNANCE – CONTROL ISSUES

4.1 In a typical investment into a high growth company, whether a loan related investment or equity investment, how much control would a typical investor take? and what is of particular importance to an entrepreneur? In particular, please elaborate on the following terms from the perspective of your jurisdiction and practice:

- a. Anti-dilution measures
- b. Rights of first refusal, pre-emption rights, drag and tag along
- c. Protective provisions
- d. Information rights
- e. Dead-lock resolution
- f. Board seats / observer rights
- g. Any other terms specific/important in your jurisdiction?

Investors into Swiss high growth companies generally require a high level of control over the venture. This is generally reached through a combination of measures and provisions in the growth company's articles of association, the investment agreement and the shareholders' agreement.

- Anti-dilution measures: Are commonly used in Swiss transactions (as from the seed financing phase) and generally included in the shareholders' agreement.
- Rights of first refusal, pre-emption rights, drag and tag along: The granting of such rights is again common and regularly seen in the transaction documentation (i.e. the shareholders' agreement).
- Information rights: Clear information rights are generally included into the transaction documentation when investing in a Swiss high growth company, since Swiss corporate law only provides for very limited information rights for shareholders, with such rights only to be exercisable in the context of a shareholders' meeting. Also, venture capitalists and private equity firms may have certain reporting duties vis-à-vis their shareholders and/or investors and, thus, the receipt of detailed information on the financial (and business) conditions of the investment is crucial.
- Dead-lock resolution: Experience shows that in Swiss transactions investors try to avoid including deadlock provisions into the transaction documentation by mutually agreeing from the outset on a set-up that is prone to such situations (e.g. by having an uneven number of board members or by providing for a casting vote for the chairman of the board of directors).
- Board seats / observer rights: Provisions on the composition of the board are typical, since, as a matter of Swiss corporate law, the board of directors of a Swiss company has extensive powers (e.g. the ultimate direction of the company, the determination of the company's organisation, the structuring of

the company's accounting system, financial control and financial planning, the appointment and removal of the persons entrusted with the management and the representation of the company, as well as their ultimate supervision).

- Any other terms specific/important in your jurisdiction? In order to protect the investment in a high growth company in case of such company's liquidation (including trade sales and IPO), investors generally ask for liquidation preferences (to be included into the shareholders' agreement), i.e. a preferential allocation of the proceeds resulting from a liquidation of the company.

5. EXIT STRATEGIES AND TIME HORIZON

5.1 Type of exit which is most common (sale to venture capital/private equity firms/funds, trade sale, write-off, initial public offering)? Typical transaction length?

Clearly, the most common exit of a private equity investment in Switzerland is the trade sale. While IPOs were popular for some time, in the aftermath of the subprime and financial crises, the Swiss IPO market remained slow and Swiss IPOs have become very rare. Overall, for 2012 only two IPOs (DKSH Holding AG and Leonteq AG) and for 2013 only one IPO (Cembra Money Bank AG) can be recorded.

The dominant position of trade sales mainly derives from the important role of the life sciences sector (biotech and medtech) in Switzerland (see also Section 3.2 above). A lot of strategic national and international investors are interested in buying into Swiss growth companies, among which spin-offs of the big Swiss pharmaceutical firms, in order to reinforce and/or fill their product line and portfolios.

The length of a trade sale/transaction can obviously vary considerably based on the complexity of the planned transaction and the transaction structure. In particular, an eventual need for an approval by any (foreign or Swiss) authority may have a timely influence on the process. Also, the "transactional experience" of the parties involved in a transaction needs to be taken into account. An indication of a typical transaction length is, thus, difficult. As a rule of thumb, however, one has to allow at least three months for a trade sale (from the first contact with a buyer until the closing of the transaction).

5.2 How are new investors dealt with in your jurisdiction? How would the issues set out in section 5 above be dealt with? Are initial investment and shareholders' agreements/shareholders' agreements upheld in the next round, or new agreement is entered into?

Again, there are no legal provisions or general rules on how new investors in a high growth company in Switzerland have to be dealt with. However, in keeping with the fact that "new money rules", we clearly see more frequently that new investors ask for a complete set of new agreements (investment and even shareholders' agreement).

At least, in case an initial investor is only partially replaced in a secondary transaction, it is likely that the shareholders' agreement entered into by the shareholders when the initial investor entered the stage, is upheld in such second financing round and the new investor accedes to the existing shareholders' agreement.

6. REGULATORY ISSUES

6.1 Any tax implications (positive or negative) that a high growth company encounters in your jurisdiction?

There are virtually no positive tax implications that are specifically targeted at high growth companies (or start-ups generally). However, Switzerland has an attractive tax regime in place insofar as tax-free capital gains are concerned. For individual investors with residence in Switzerland, the gains realized on the sale of equity investments is generally tax-free; similarly, Swiss-resident corporate investors benefit from a virtual tax free gain if they sell a stake of at least 10% in a company.

Notwithstanding this, capital gains derived from the sale of employee shares may not be entirely tax-exempt depending on certain terms and conditions and time limits. In addition, the gain realized by selling shareholders may become subject to tax if and to the extent that the company sold distributes freely distributable funds to the purchaser within 5 years after the acquisition (so-called indirect partial liquidation). These tax implications, however, can be avoided by careful drafting of the share purchase agreement. Finally, for VC fund managers, carried interest may become subject to tax under certain conditions.

6.2 In addition to any of the issues set out above, any other regulatory incentives or constraints with respect to high growth companies? Any constraints deriving from obligation for local participation in a high growth company? Co-investment obligation? etc.

The main regulatory constraints with respect to high growth companies are those that affect the fund industry, i.e. the marketing and distributing of fund units in or from Switzerland by foreign VC funds and their managers as well as the structuring and managing of Swiss-based and foreign-based funds by Swiss VC managers.

7. OTHER

7.1 Please elaborate on any other issues relevant to your jurisdiction with respect to high growth companies which have not been discussed in responses to earlier questions (if any).

In general, the amounts invested in the area of Swiss venture capital is rather low compared to international standards. This may also be due to the fact that there is only a limited number of Swiss and especially foreign-based VCs which are generally more active in later stage financings.