Go West.

Venture Financings and Expansion Projects in the United States

Practical Guidelines for German Technology Companies

orrick

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Introduction

We have dedicated technology lawyers, in all major hubs around the world, who support young German technology companies on their growth trajectory through all stages.

As one of the top tech law firms in the United States, we help bring the U.S. and German entrepreneurship ecosystems closer together. We especially want to help German technology companies looking to expand into, and scale in, the U.S. market.

This guide will help founders of, and investors in, German technology companies seeking to raise capital from U.S. investors or simply to expand into the U.S. market.

We will give helpful tips on when and how to look for a U.S. investor and discuss key differences between funding rounds in Germany and the United States. We will also examine the benefits and challenges of "flipping" a German GmbH into a U.S. company, often considered a cornerstone in developing a successful "Silicon Valley story."

Many German technology companies cannot afford to ignore the U.S. market and will sooner or later consider having a presence "on the ground." A U.S. market presence can help to achieve scale more quickly and help the company gather important market intelligence or to tap into rich(er) talent and technology pools. A U.S. presence will also often help to attract U.S. investors. Thus, in the second part of this guide, we will discuss some operational topics for entering the U.S. market, ranging from protecting intellectual property rights in the United States, privacy considerations when transferring personal data from and to the United States to key employment matters, in particular, participation programs in the United States and how to make typical German programs work for U.S. beneficiaries. We will also discuss some areas of law that are, especially when compared with the German market, specific for the U.S. market but of great importance for any foreign technology company coming to the U.S., including trade secrets and how to manage litigation risks.

We hope you enjoy this guide. If you would like to discuss it further, please get in touch. You can learn more about the authors of this publication in Chapter D. We would also love to learn about your experiences with the topics addressed herein. So please share them with us. We constantly strive to evolve and grow in order to best serve our clients.

— Your Orrick Team

A. Financing

1 When Looking for U.S. Investors

With our global platform across many of the world's tech hubs, we regularly work with German entrepreneurs and start-ups looking for funding from U.S.-based venture capital and corporate venture capital investors.

Although it is certainly still a steep uphill climb for non-U.S. start-ups to obtain funding from most U.S. investors when coming into the U.S. market, we have seen increasing investment activity in European and, particularly, German start-ups over the last few years. There are a number of trends leading us to believe that U.S. investments in German companies will continue to gain momentum, including:

- The maturing entrepreneurial ecosystem in Germany;
- The lower price tags for German start-ups and top-notch developer teams outside the U.S.; and
- The expected reallocation to Germany of investment dollars that had been earmarked for European start-ups following the Brexit.

With financing rounds by European investors in most cases still remaining smaller than U.S. financing rounds for comparably mature emerging companies, it remains a very attractive (and sometimes the only) option for a German start-up to build its business in Germany, raise some money (often a super seed round or a (pre-) series A round) in Germany, use the proceeds to build up some traction in the United States and then go after a much larger later stage round in the United States. With their extensive operational experience, financial firepower, roll-out and support capabilities to assist their portfolio companies, such smart money from U.S. investors can be very attractive.

Based on our experiences, we have summarized a few tips for German start-ups to increase their chances of landing a U.S.-backed financing.

Find Your Access Point

German start-ups should be aware that they are facing stiff competition. With their networks in Silicon Valley and other major tech hubs such as New York and Boston, U.S. investors are sitting at the epicenter of the world's biggest entrepreneurial ecosystem (we know, with the notable exceptions of Tel Aviv and, increasingly, Berlin). This system is self-sustaining due to, amongst others, positive selection patterns as the best founders and companies tend to gravitate to them. Add the natural bias for home markets and it becomes clear how hard it is for an outsider to stand out.

Any U.S. investor will ask why a German start-up is not seeking funding in its home market. Especially early-stage investments in a start-up that is not already on the ground in the United States are difficult to pull off. U.S. investors will often request a minimum of U.S. traction. There needs to be trust right from the start, especially when there is little geographical proximity between investor and start-up (remember that many angel investors from Silicon Valley invest only in companies they can reach in sixty minutes or less).

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Building Networks – Orrick's Total Access Events

An excellent way for international founders to build their networks in the tech centers on both the East Coast and West Coast is Orrick's highly regarded Total Access Events Series. These events provide entrepreneurs business, tactical, legal education and coaching. Presented by experienced industry CEO's, venture capitalists and Orrick lawyers, Total Access offers insights on cutting-edge issues and an opportunity to network with leading professionals in the start-up community. Access is free.

To learn more about the current program and to make sure you get an invitation go to ***www.orrick.com/Total-Access.***

To overcome these barriers and get in front of U.S. investors, the founders need to be on the ground and find their way into the investors' networks. Here, we recommend concentrating on investors that already have a proven track record of investing in European start-ups, preferably German start-ups, as for some U.S. investors the step from investing in a UK or Irish start-up into one from Continental Europe still seems to be a big one.

Sending out a blast email with a pitch deck to a bunch of investors is not a particularly promising strategy in Germany and is less so in the United States. Make no mistake, unsolicited pitches sent to an investor are most certainly deleted unread (there are simply too many) and, especially in early stages, engaging paid financial intermediaries (placement agents or "finders") to help generate leads is considered a waste of (investors') money and simply signals immaturity and naivety. Founders should spend time and energy developing and maintaining relationships with important players early on and seek a solid referral to an investor from someone in the investor's trusted network. For many investors, the first screening criterion is the effectiveness and creativity in which the prospect obtained an intro. Ultimately, one of the key jobs of the CEO of a start-up is getting to know investors and persuading those investors that she is worth backing. Because venture capitalists are busy, with ever-changing schedules, this can be a frustrating exercise for those who are not on the ground.

It is often also advisable to get a smaller (German) venture capitalist with good ties to larger U.S. venture capitalists, demonstrated by a solid track record of follow-on investments by its network partners, into the cap table.

Come Prepared

When pitching to U.S. investors – this holds true both for venture capital and corporate venture capital investors – preparation tops zeal. Bear in mind that the renowned investors have to screen at least hundreds and often thousands of ideas every year. With time at a premium, it is imperative for each German start-up to come prepared and make it as easy as possible for a potential investor to check the boxes.

We are often asked if this means that a German start-up has to swap into a U.S. legal form (the famous "Flip", see Chapter A.2 below). Well, it depends. While some U.S. investors still only do investments in U.S. companies or at least have a strong preference for U.S. companies, over the last years we noted a change in attitude. Many U.S. investors today are not "afraid" of investing in a German Limited Liability Company (*Gesellschaft mit beschränkter Haftung* – "GmbH") any more (though, as we will see, there might still be other good reasons for a Flip).

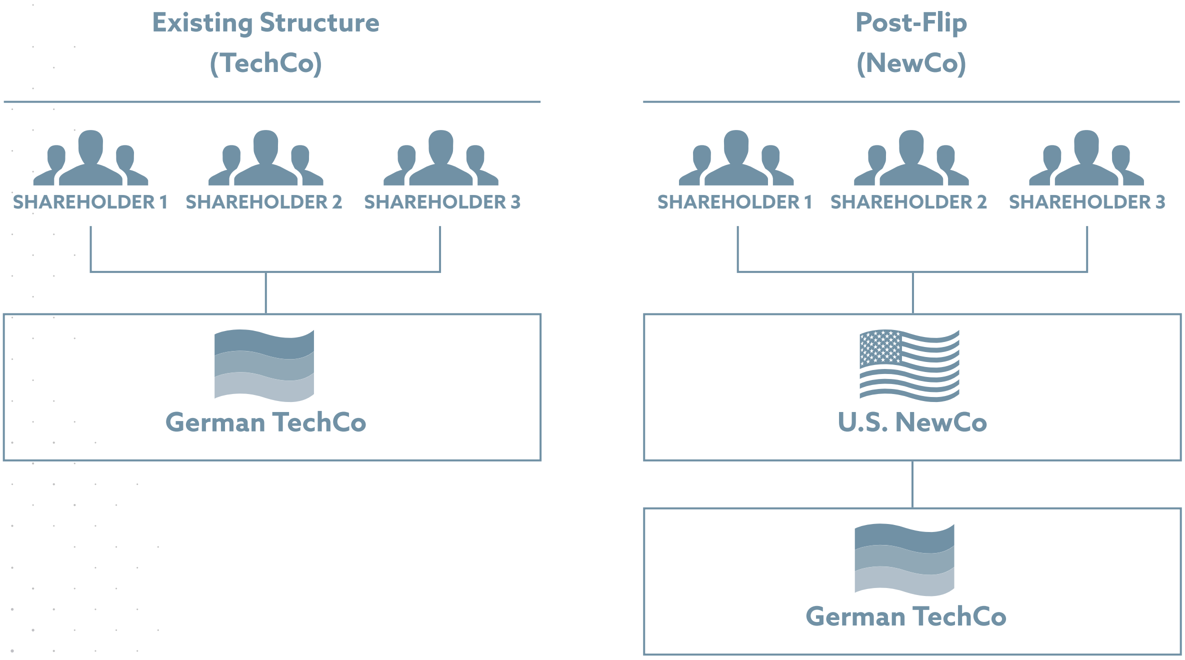
But even with their start-up organized as a GmbH, German founders can make life easier for their prospective U.S. investors. If attracting U.S. investors is a serious prospect, founders should ensure that the shareholders' and other agreements they enter into with their early stage investors and co-founders meet what a later stage U.S. investor would expect in a typical U.S. deal, *e.g.* typical preference rights and the flexibility to pursue further financing rounds and exit options (for a summary of typical U.S. deal terms see Chapter A.3 below).

When trying to entice U.S. investors with the potential of the U.S. market for the German start-up's product, it is also crucial that the start-up has conducted at least a basic compliance check of its product with U.S. regulations and that with the help of a qualified U.S. counsel a comprehensive IP strategy has been developed to ensure that the company has and retains essential IP rights (for more on this, see Chapter B.2 below).

There is More Than Your Pitch

When speaking at conferences or working with German entrepreneurs, it is surprising how often we hear that German entrepreneurs face a disadvantage because they can't pitch like their U.S. peers. American entrepreneurs don't have to overcome the language barrier. And it certainly helps any entrepreneur to take a page out of Y Combinator's playbook when preparing their start-ups for demo day. But, pitching is not a theater play. Some excitement can be contagious, but don't force it.

What U.S. investors are looking for is evidence that there is a real customer need and market opportunity with growth potential, a strong team that can execute, an exit strategy and, as should have become clear from the above, a good reason why the German start-up seeks U.S. investors. Keep in mind that many U.S. investors need to deploy funds much larger than their European peers, so prepare for the question "how big can this be" and understand fund economics.



Main Reasons for a Flip

- Improved access to U.S. venture capital markets.
- Going public in the United States is much easier.
- Higher valuation of the company due to the "Silicon Valley story".
- Easier access to rich U.S. talent pool with U.S.-style ESOPs.

2 Flips – How to Become a U.S. Company

Many German technology companies are initially set up as a GmbH or its "little sister" the UG (haftungsbeschränkt) in which the founders, angels and maybe first institutional financial investors acquire a stake (either directly or through personal holding companies). As we will see, once the startup has somewhat matured it may become an attractive option to change this initial corporate set-up and "flip" it into a U.S. company.

What is a Flip?

A "Flip" refers to the "transfer" of a German start-up to a U.S. legal structure. In this process, the shareholders "swap" or "flip" their shares in the business-carrying German company ("TechCo") for shares in a U.S. company (often a Delaware Inc., "NewCo").

As a result, between the founders and TechCo, a new parent company is established: while NewCo becomes the new parent company in which incoming investors would invest, TechCo becomes a subsidiary.

Usually, intellectual property rights and employees remain with TechCo while NewCo assumes the role of a holding and management company that sometimes also enters into business relationships with customers in the United States (though for various reasons, it is often more advisable to establish another new U.S. company beneath NewCo, *i.e.* a sister company to TechCo, to act as operating company in the U.S. market).

Reasons for a Flip

A central motive for the Flip is that in many cases the start-up will receive improved access to the significantly more liquid U.S. venture capital markets. The U.S. has 7 of the top 20 start-up locations worldwide, with Silicon Valley being number 1. The only German location is Berlin as number 7 (figures taken from the 2017 Global Startup Ecoystem Ranking published by the Global Startup Genome Project).

The United States has a higher number of potential investors, has a much more vibrant and developed venture capital scene, and has a higher disposition to invest, especially in riskier ventures than Germany or Europe. Also due to deeper sectoral diversification, investors may sometimes offer better know-how, contacts and guidance for the newcomer.

Moreover, by operating through a domiciled U.S. company, consisting formal investment restrictions may cease to apply, *e.g.* institutional investors may be prohibited by their charters from investing in and buying securities of non-U.S. companies.

Start-ups with a "Silicon Valley story" also tend to receive higher valuations in future financing rounds and in exit scenarios. With a rather flat German IPO market, in particular for young technology companies, going public on NASDAQ or NYSE is an appealing alternative. When considering a trade sale to a U.S. acquirer as an exit route, it must be noted that valuations are higher in the United States and many U.S. corporations have ample experience in acquiring emerging companies as part of their innovation portfolio, while start-up M&A is still not that common in the German market (though definitely on the rise). Operating through a U.S. company may ease each of these exit processes. Furthermore, certain favorable valuation methods such as the U.S.-style "forward or reverse triangular statutory merger" are not available for non-U.S. companies.

Finally, tapping into the rich talent pool of Silicon Valley and other U.S. tech hubs is easier for a U.S. legal entity as it can offer standard, market-tested equity-based employee participation plans with stock options (for details, see Chapter B.4 below).

Which U.S. Company Form to Choose

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

In Delaware, it is common to establish one's company as a so-called "C Corporation". The corporation will then be taxed separately from its owners under U.S. federal income tax law. Its counterpart, the so-called "S Corporation", refers to a corporation whose shareholders are subject to income tax instead of the corporation itself, based on their pro rata shares of income. Every profit-oriented corporation will be automatically qualified as a C Corporation, whose shares do not need to be held by resident or citizen individuals or certain qualifying trusts, as it is the case for S Corporations.

Concerning which legal form to elect, sometimes the Limited Liability Company ("LLC") is discussed. However, although this newer, somewhat more flexible legal form is most akin to the German GmbH which German newcomers are familiar with, it is often not suitable for the purposes of German technology companies, e.g. U.S. investors often do not want LLC interests and while there are employee equity plans for LLCs, they are non-standard and will cost significantly more to create and maintain when compared to "standard" C-Corp equity plans.

After incorporating in Delaware, the corporate entity will need to qualify to do business in the relevant federal states. This is easily done and cost effective. In order to minimize liability risks and facilitate a centralized administration and future transactions, it is strongly recommended to opt for a holding company as a TopCo with respective operating as well as sales and distributions subsidiaries. However, if such a structure should be too complex for the start-up at an early stage, this can be implemented later.

How to do a Flip?

Here is a brief summary of the typical steps to be taken in a Flip. The best transaction structure will, however, always depend on the specific case at hand. Founders and investors of TechCo are well advised to bring an experienced counsel on board who can cover both the German and the U.S. tax and corporate law angles.

- **Step 1:** The current shareholders of TechCo incorporate NewCo.
- **Step 2:** The existing shareholders of TechCo transfer 100% of the shares in TechCo to NewCo. This will require a transfer deed to be notarized in front of a German notary. In exchange, the existing shareholders of TechCo receive shares in NewCo.
- **Step 3:** The current shareholders of NewCo and potentially the new investors enter into the typical agreements governing their rights and obligations as shareholders of NewCo, including exit options, preference rights etc. (for details, please see Chapter A.3 below).

Location Considerations: Where to set up Shop in the United States?

When deciding where you are going to set up your place of business, take into account that some investors appreciate local proximity. As Silicon Valley is a very expensive place to do business, with fierce competition for talent, be sure this is the right place for your business. Some alternatives, depending on the main focus of business, are for example:

Biotech: Boston/Washington, D.C.

Cybersecurity: Washington, D.C./New York

Media/Games: Los Angeles/New York

Insurance: New York/Chicago

Hardware/Enterprise Software: Seattle

FinTech/Ad Tech/Publishing: New York

Other: Austin

Delaware Inc. Features in a Nutshell:

Quick & Easy Incorporation — The incorporation of a Delaware Inc. happens quickly (within 1 day), underlies low formal requirements (possible per fax) and is low-cost (graded depending on the share capital).

Simple Decision Making Processes — The Delaware Inc. follows the "one tier" governance approach, *i.e.*there is only one operative and supervising board (board of directors). In addition, decision making is faster and simpler: mostly majority vote or written consent is required, rather than the super majority or unanimous consent.

Directors Liability — Directors' risks of being held liable for assessing the company's future business prospects when making financing decisions tend to be less strict in the U.S. than in Germany.

Corporate Capital — Statutory minimum capital requirements and strict capital maintenance rules, as they are characteristic for the German corporate law, do not exist for the Delaware Inc.

Certain Tax Considerations

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

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

For German income tax purposes, the determination of the fair-market value of shares in a non-listed company must primarily be derived from comparable sales in the same share class in the last year or, in their absence, from a commercially accepted valuation method.

With respect to the effective tax burden, the situation differs whether the respective shareholder of TechCo is a German corporation or a natural person subject to German taxation.

- For corporate shareholders, the regular German tax relief should often be available. Thus, 95% of any gain from the Flip would be tax exempt, with the remaining 5% increasing such corporate shareholder's taxable income. A loss would be fully tax exempt (no tax relief). Depending on the local trade tax multiplier, the 95% tax exemption leads to an effective taxation for a German corporate shareholder at approx. 1.5% of the gain from the Flip.
- In contrast to that, if the shareholder is a natural person subject to German taxation and holds an equity stake in TechCo of at least 1%, her gain from the Flip would only be 40% tax exempt, with effective taxation often ranging up to approx. 28.5%.

When contemplating a Flip, founders and investors should obtain advice from qualified tax lawyers both in Germany and the United States. For example, to avoid negative tax implications, it is important to demonstrate that NewCo is a "real" enterprise and not just a letterbox. NewCo should not become a "dual resident" from a tax perspective: Germany would treat NewCo as a German tax payer if it had a German central place of management, which may result in difficult double taxation situations. So the executive board of NewCo should be staffed in a way that the "center of gravity" for management of NewCo can be demonstrated to be in the United States. A clear distinction of management functions (in the United States) and shareholder supervisory functions (may be located in Germany) should be implemented to that end.

3 VC Deal Terms – United States vs. Germany

More often than not, a U.S. venture capitalist and a German technology company agree on the commercial terms of an investment transaction and think that the hard work is done but quickly find themselves at an impasse over the way the transaction will be documented. With the increase in cross-border venture capital transactions, particularly U.S. investors taking stakes in German technology companies, this is an issue that companies and investors are dealing with more regularly than ever before.

A typical venture capital transaction, whether it is an investment into a U.S. or a German company, involves the following key elements:

- The Investor purchases equity in a private company in return for cash.
- The company and, in some cases, its key executives or founders provide investment related protections (representations, warranties or indemnities) to the investors about the company and its business.
- The investor typically receives a class of preferred stock which provide for preference rights in case of a liquidity event and certain other rights, including rights to receive financial and other information relating to the company (for details see below).
- The investor is given board membership, granted board observer or other representation rights.
- The rights of the parties on an "exit", particularly an initial public offering or sale of the company, are defined.

From a commercial perspective, a venture capital transaction (where an investor or a group of investors privately acquire shares in a company) should essentially be the same transaction, regardless of jurisdiction. In practice however, documentation styles vary considerably outside the United States, which can be frustrating to many venture capitalists, the majority of which are U.S. based.

This chapter seeks to identify several of the more salient aspects in which typical U.S. and German financing round documentation diverge from each other. When comparing documentation used in typical U.S. and German venture capital transactions, a number of key differences emerge, including, in particular:

- Form and style of documentation (including the terminology used);
- Representations and warranties; and
- Scope and style of investor protections.

Which Agreements are Typically Entered Into?

German Financing Rounds: Investments in a German start-up (which are most often set up either as a "GmbH" or a "UG (haftungsbeschränkt)") are usually implemented through a share capital increase. In the course of such increase, new shares are created, which the investors subscribe for against payment of their nominal value. In addition, the investors will undertake to pay additional funds, *i.e.*, the bulk of the investment funds, into the company's capital reserves or to grant a (often convertible) shareholder loan to the company. As part of the financing round, all existing shareholders, the new investors and typically the company will enter into an investment agreement and a shareholders' agreement (sometimes the agreements are combined into one "investment and shareholders' agreement").

- In the investment agreement, the parties set forth the terms and conditions for the capital increase, the details for the additional funding (amounts, milestones etc.) and guarantees given by the company (and in many cases by the founders and to a lesser extent by existing investors) and the remedies in case of a breach.
- In the shareholders' agreement, the parties set forth their rights and obligations as shareholders of the company, including corporate governance aspects (managing directors, optional advisory board, appointment rights, etc.) and certain veto rights for the investors, transfer restrictions, drag- and tag-along rights as well as provisions regarding liquidity events and the distribution of the resulting proceeds.

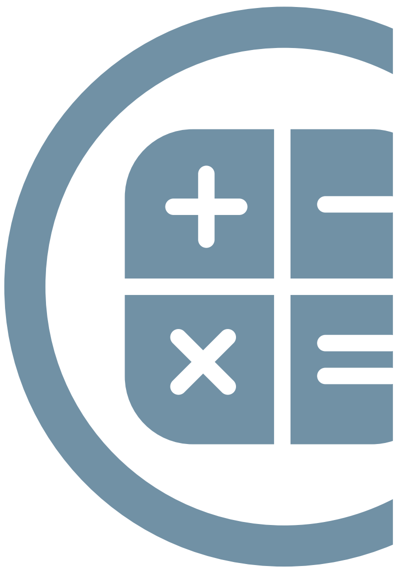
In most cases, both agreements will need to be notarized. It should be noted that the management board of the German start-up cannot implement a financing round. Rather, the decision about a financing round rests with shareholders as the capital increase requires a shareholders' resolution be adopted by at least 75% of the votes cast. For practical purposes, in many cases de facto, the consent and active support by all shareholders is required or at least very advisable.

U.S. Financing Rounds: It should be noted that unlike in the German market, where standards for venture financing transactions are only slowly developing, well established market standards exist in the United States, which helps in simplifying the implementation of financing rounds following the investors' positive funding decision.

U.S. financing rounds usually include the following agreements:

- The new investors and the company will enter into a stock purchase agreement under which the new investors will typically purchase preferred stock (please see below for a summary of customary preference rights in U.S. transactions). This stock purchase agreement will contain certain representations and warranties given by the company, including regarding the validity of the preferred stock being purchased and in most cases certain operational and financial representations and warranties.
- The company's charter (also referred to as certificate of incorporation), together with its bylaws, will set out certain rights of the shareholders, including liquidation preferences, anti-dilution protection and veto rights (for details see below).
- In an investors' rights agreement, the investors are granted certain rights, which typically includes information rights, pre-emptive rights in case of future issuance of new securities and registration rights pursuant to which the investor can request the company to publicly register the company's common stock with the SEC in connection with or following an initial public offering of the company.
- In a separate voting agreement, the parties stipulate how the stockholders will appoint and remove directors on the company's board. These agreements may also contain provisions regarding the shareholders' obligations to vote in favor of exit transactions (known as a "drag along"), provided that certain criteria are fulfilled (*e.g.*, approval of the transaction by the board, a majority of common stock and a majority of preferred stock).
- Finally, the parties may enter into a separate right of first refusal and/or co-sale right agreement, which states that if holders of common stock propose to sell their shares to a third party buyer, the holders of preferred stock have a right of first refusal to match the third-party offer or alternatively the holders of preferred stock can participate in the sale ("co-sale") by selling their preferred stock on a pro-rata basis.

Please note that the above list is just a high-level summary and that these agreements can vary across transactions and sometimes the agreements are combined.



Representations and Warranties

While U.S. companies will usually give representations and warranties in the transaction documentation, the investment agreement in a German financing round will include guarantees within the meaning of Section 311 German Civil Code that provide for a liability irrespective of fault. It should be noted, however, that in practice the difference is mainly in terminology.

Where German and U.S. investment agreements differ is the manner in which disclosures (or exceptions) to the warranties are given. While the form of delivery of "specific" disclosures does not differ too much (in the United States and Germany, one usually finds a schedule of exceptions or disclosure schedule, while for example in U.K. investment rounds, a disclosure letter is the more frequent form), it is the additional inclusion of "general" disclosures in Germany that is the material difference. General disclosures are typically disclosures of those matters of which the investor is deemed to have public knowledge, such as matters on public record and frequently the entire data room (or at least a large bundle of specific documents) being deemed disclosed (though, in Germany generally no disclosure against "core guarantees" such as title, freedom of third party rights with respect to shares, is accepted). General disclosures, however, are not a usual feature in the U.S. transactional landscape and as such, by and large, they are met with resistance by U.S. investors.

In Germany, a number of limitations are given on the liability of the representations and warranties, such as time limits within which claims must be made, caps on liability of the warrantors and minimum financial levels for claims before they can be made. These limitations are frequently the subject of detailed negotiation between the parties. While these types of provisions are common in U.S. mergers and acquisitions and private equity transactions, they are far less common in U.S. venture financing transactions. In the U.S., most venture financing transactions do not have a time limit (other the applicable statute of limitations), caps on liability or minimum financials levels for claims. Indeed, in the U.S., there is typically not a provision in the agreement that details how investors would even bring a claim against the company.

Finally, in the United States, founders do not typically make representations or warranties as individuals. However, in Germany, at least, business guarantees are often given by founders, typically capped as a 2-3 multiple of annual salary.

One area of common ground between representations and warranties, given in typical U.S. and German venture capital transactions, is that it is rather unusual for actual claims to be made. The threat of litigation is nonetheless seen as a valuable way of ensuring thorough disclosure and of driving an investor's due diligence investigation of a company.

Typical Preference Rights and Protective Covenants in the United States and Germany

Below are some of the preference rights and protective covenants one typically finds in the U.S. and the German venture capital market. Of course, the use of such investor-favorable deal terms depends, *inter alia*, on the current market environment and how "hot" the respective company is and how many investors are competing to get the deal. Overall, we noticed in recent quarters a slight shift to more investor-favorable deal terms, with the U.S. venture environment remaining below peak levels of the past few years, although venture capital sentiment is still well above historic averages.

- **Liquidation Preference:** Shares of preferred stock will generally be entitled to receive liquidation preference prior to any payment of proceeds to holders of common stock upon a change of control or other liquidity event. This downside protection is an amount generally equal to 1x the amount invested, although it could be higher, which is paid in preference to other series of stock. While in some cases the liquidation preference is "participating" or "capped participating," the most common structure in U.S. venture transactions is 1x, non-participating. According to our experiences, German transactions generally show similar liquidation preferences, in many cases investors receive a 1x non-participating liquidation preference (*einmalige, anrechenbare Liquidationspräferenz*).

- **Conversion Rights:** Shares of preferred stock are generally convertible into shares of common stock on a 1:1 ratio. In the event of a change of control or other liquidity event, the holders of preferred stock have a right to convert to common stock and will generally elect to do so if it results in them receiving a greater portion of the proceeds from such transaction. The preferred stock will usually convert automatically upon an initial public offering of the equity securities of the company.

- **Anti-Dilution Rights:** Anti-dilution protection has long been a standard feature of both U.S. and German venture capital transactions. Within the United States, almost all transactions use a broad based weighted average formula for calculating anti-dilution. That said, certain later stage transactions (*i.e.*, 12-18 months pre-IPO) and companies raising capital from more traditional private equity funds (rather than venture funds) in the U.S. will sometimes include a ratchet or narrow-based weighted average protection. In the German market, we have recently seen most anti-dilution protections to be modeled as a narrow-based weighted average, though full-ratchet covenants are still seen more often in sectors where investment funds are particularly scarce, *e.g.*, in the life science sector.

The main difference between anti-dilution rights in the United States and Germany is not so much the way in which the adjustment is calculated but rather the manner in which any anti-dilution benefit is provided to the existing shareholders. In Germany, upon the occurrence of an anti-dilution event, the usual practice is to obligate all shareholders to vote in favor of a capital increase and grant the investor entitled to the anti-dilution protection such number of shares to compensate for the requisite dilution. In the U.S., due to the potential impact of deemed dividend rules (*i.e.*, the granting of additional shares being seen by the IRS as deemed dividends), additional shares are not granted and instead there is an adjustment to the conversion rate of the preferred stock to common stock, such that the investor does not hold additional stock today but does hold and control a greater percentage of the company on an as-converted basis.

- **Voting Rights:** Preferred stock generally has the right to vote on a number of items, including specific preferred directors on the board and to approve certain material corporate transactions. Such protective provisions would prohibit the company from taking such action without the consent of a certain percentage of the preferred stock. Such matters typically include liquidation of the company, effecting a sale of all or substantially all of the company's assets, redemption of shares, assumption of debts or creation of debt securities beyond certain amounts or ratios, changes to the company's ESOP, etc. In addition, some companies will permit board members elected by the holders of preferred stock to have veto rights or special votes with respect to management and operational decisions.

  Based on our experience, U.S. investors – particularly those on the West Coast – tend to request fewer veto rights when it comes to management and day-to-day operational decisions, opting instead to grant more freedom to the founders in order not to stifle the agility of the company. Investors in the German market often tend to require more control than their U.S. peers.

  Pro Rata or Pre-Emptive Rights: Typically, holders of preferred stock will have the right to purchase a pro rata portion of any new issuance of equity securities or convertible debt securities of the company. Similar provisions are also found in the German venture capital landscape. Please note, however, that German law requires new issuances of shares to be first offered pro-rata to the existing shareholders unless otherwise waived by the shareholders either in relation to the specific case at hand or generally.

- **Right of First Refusal and Co-Sale:** These preferences provide the rights of holders of preferred stock to a right of first refusal with respect to any sale of common stock by certain key holders of common stock of the company (typically any holder of 1% or more of the company's common stock). In the United States, the company will typically have a primary right of first refusal on all sales of common stock, while the holders of preferred stock will have a secondary right of first refusal if the company declines to exercise its right of first refusal. In addition, such holders of preferred stock are granted co-sale or tag-along rights with respect to transactions where the right of first refusal is not fully exercised. In German market transactions, tag-along rights are frequently granted to every shareholder (*i.e.*, not only preferred shareholders) and rights of first refusal or pre-emption rights apply in the case of a transfer of common stock or preferred stock. In both the United States and Germany, there are customary carve-outs, including for transfers to affiliates.

- **Information Rights:** Generally, the investors' rights agreement will provide that certain large investors (often referred to as "Major Investors") will be entitled to receive financial statements and annual budgets from the company and will have the right to inspect the property of the company at reasonable times.

  According to our experience, in German financing rounds the investors' information rights tend to be broader and apply to all shareholders irrespective of the size of their holdings. Please also keep in mind that under mandatory German law the holders of shares in a German GmbH have unalienable information rights even if they only hold one share. Similarly, stockholders in Delaware corporations have statutory information rights, so certain U.S. companies will include a "statutory information rights waiver" in the stock purchase agreement, whereby the non-Major Investors waive their information rights.

- **Registration Rights:** Holders of preferred stock generally have the right to force a company to file a registration statement with respect to their shares, even if the company has not already gone public, typically within five years following their investment. Similarly, such holders will have the right to piggyback on other registration statements filed by the company, subject to certain exceptions, including public filings relating to ESOPs. In our experience some companies backed by U.S. investors have been able to exclude an initial public offering from the registration rights requirements (meaning only piggyback or S-3 registration would be able to be forced by the holders of preferred stock). In practice, registration rights are rarely if ever exercised by U.S. investors other than in connection with the company's IPO.

  By contrast, in any listing of a company's shares on a German exchange or another European market, the entire issued share capital of the company is included. Consequently, registration rights are not relevant when seeking a listing outside of the United States.

- **Drag-Along Rights:** In the voting agreement, the stockholders often agree that in the event a minimum number of shareholders (and the Board if applicable) approve a liquidity event, all other shareholders are forced to vote their shares in favor of the transaction. The threshold vote usually requires the vote of a majority of the preferred stock as well as either a majority of the common stock or a majority of all capital stock. The vote sometimes includes separate votes of individual series of preferred stock, particularly where different series invested at varying valuations and may have different economic incentives. Here, a balance needs to be found between the interests of the company and the founders, which is to ensure that stockholders will vote in favor of a company sale (since acquirers will often require that 90%-95% vote in favor), and the interests of investors who will often want a separate vote in order to protect their economics. In practice, companies sometimes agree to a series vote but structure that series vote as one that goes away once the multiple of the return for an investor on a transaction reaches a certain multiple, *e.g.* 2x-3x.

  In the German market, we usually see drag-along rights that are triggered if shareholders holding together more than 50% of the entire nominal capital of the company request an exit. In addition, often an investor majority (and sometimes even a majority of each class of preferred shares) is required.

B. U.S. Expansion Projects

1 How to Use and Protect a Trademark in the United States

Often, a German technology company's brand is one of its most valuable assets. By properly registering and using the company's trademark, it can make sure that its brand is fully protected as the company enters the U.S. marketplace.

Two Ways of Obtaining Trademark Protection in the United States

In the United States, like in Germany, it is somewhat unique that one can obtain limited protection for a trademark without first filing a trademark application. A company can obtain common law trademark rights – at least with respect to the geographical area that company is operating in – just by using its mark in connection with its product or service and providing it in commerce. Thus, by just using a trademark in commerce in the United States, a company will begin to accrue some rights to the mark (for more see below).

Obtaining a federal trademark registration from the United States Patent and Trademark Office ("USPTO"), however, confers certain important rights and legal benefits, including a legal presumption that the trademark is valid. A federal registration also serves to put others on notice of the company's use of the trademark. As a registered trademark will appear in the USPTO's database, it may also help ward off potential infringers from adopting a confusingly similar trademark.

Obtaining a Federal Registration

To obtain a federal registration for a trademark in the United States, an application must be submitted to the USPTO along with the government filing fees, which are currently $275 per class. The USPTO will register many different types of marks, including word marks, logo marks, and slogans, as well as trademarks that consist of trade dress or product packaging. The trademark application will need to include a clear drawing of the specific trademark being registered, such as the specific words typed out or an image file of your logo. The application will also need to include a clear description of the goods and services for which the mark is used, along with the correct classification number for these goods and services. The USPTO maintains a searchable database of acceptable descriptions for goods and services located at www.tmidm.uspto.gov/id-master-list-public.html. The application will also need to include accurate ownership information for the owner of the trademark, including the entity name, address, entity type and country or state of citizenship.

Finally, the application will need to specify on what basis the applicant is seeking registration for the trademark. The two most common filing bases are either that the trademark is currently in use in interstate commerce in the United States – known as a 1(a) basis – or that the trademark is intended to be in use in the near future in interstate commerce in the United States – known as a 1(b) basis. An application filed on an in use basis will need to include specimens showing the mark being used in connection with a product or service being offered for sale, along with the dates on which the trademark was first used. An application filed on an intent to use basis will not need to include this information, however, the applicant will need to later file either an Amendment to Allege Use or a Statement of Use submitting specimens and dates of first use before the trademark can actually register.

There are, however, two additional filing bases for submitting a trademark application in the United States, both of which may be more attractive for a company based outside of the United States to utilize. One such additional basis relies on an existing, valid registration in the applicant's country of origin for the same mark being applied for in the United States. This basis is referred to as a 44(e) filing basis. To complete an application on this filing basis the applicant will only need to provide the USPTO with a true copy of the existing registration for the mark, along with a verified statement that the applicant has a *bona fide* intent to use the mark in commerce in the United States. A fourth filing basis involves the extension of an international registration for a mark filed through the World Intellectual Property Organization (WIPO) into the United States. This basis is referred to as a 66(a) filing basis. Both of these filing bases do not require specimens of use to be submitted to the USPTO in order for the mark to get registered, which in some cases make these filing bases more attractive for German technology companies coming to the United States.

The application process typically takes about a year to complete, with the application first reviewed by an examining attorney about three months after being filed. If the examining attorney finds any issues with the application, she will issue an Office Action, and a response will be due six months later. Once an application is reviewed by an examining attorney and found acceptable, it will be published in the Official Gazette of the Trademark Office. Subsequently third parties may file a formal opposition against your application if they believe the application is in violation of their rights. If an application does not receive an Opposition (or after an Opposition is successfully defended against), the USPTO will then issue a registration certificate if the application was filed based on use (1(a)), based on a foreign registration (44(e)) or based on a WIPO application (66(a)); if the application was based on an intent to use (1(b)), then a Notice of Allowance will be issued. For applications that receive a Notice of Allowance, the owner will be given six months to either file a Statement of Use or an extension request. The mark will need to be in use in the United States within three years after the Notice of Allowance is issued.

Once granted, a registration will remain valid as long as the mark continues to be used and the registration is renewed. The applicant will need to file documents with the USPTO attesting to continued use of the mark before the sixth anniversary and then again before the tenth anniversary of the registration date. After that, the mark will need to be renewed every ten years.

How to Use and Protect Trademark in the U.S. without a Registration

Many companies are interested in protecting their brands but are sometimes unclear about how to protect a trademark and, most importantly, how to use it properly. As mentioned above, trademarks do not have to be registered with the USPTO in order for the owner to have rights. However, it is advisable to file a trademark application with the USPTO in order to obtain a higher level of protection and certain benefits.

Although the circle R symbol ® cannot be used until the trademark is registered with the USPTO, the company can use a ™ or ℠ superscript to indicate that it is claiming common-law rights in its mark. When the company is using a trademark in its advertising material or on its website, it should consider using the ™ or ℠ superscript in the upper right-hand corner of the mark. We advise using the ™ or ℠ superscript in the first or most prominent use of the mark on the web page or collateral. In other words, the first time the trademark appears in the collateral, advertisement or web page. It is not necessary to use it every time, but the most prominent usage will put viewers or readers on notice that the company is claiming common-law rights to that mark. The ™ or ℠ superscript can be a great deterrent to other individuals or entities who are considering the same or similar mark for their product or services.

It is also important to highlight the trademark in some way to set it apart from the rest of the company's advertising language. It is not necessary to capitalize the trademark, but it is a good idea to highlight it in some way to pull it out from general text, either through bold, underline, italics or a different font or stylization.

Another common mistake many make is to use a trademark as a noun or a verb. It should be ensured that the trademark is only used as an adjective, not as a noun or verb, or as a plural or possessive. For example, "Our ORRICK legal services support start-up companies who are looking to…."

2 International Data Transfer with the United States

The transfer of personal data such as employee or customer data, from the EU to the United States has become a hot topic for many companies, not only for legal but also for business reasons.

In particular, the outsourcing of data processing services to U.S. vendors should thus be carefully considered and planned.

General Requirements for Data Transfers – The New EU/U.S. Privacy Shield

Under current German data protection law and also under the upcoming new EU Data Protection Regulation ("GDPR")—which threatens with fines of up to 4 % of global turnover and easy damage claims before courts—any transfer of personal data must pass a two-step test: (i) would the data transfer to another legal entity be permissible if it was to take place within the EU/European Economic Area ("EEA"), and (ii) is the country to which data shall be transferred approved as providing for an adequate data protection standard, or are other appropriate means to protect the data in place?

Passing the First Step

As with any data transfer to another entity within the EEA, any data transfer to third parties or affiliates outside the EEA must be justifiable. When engaging an entity with performing certain data processing operations, for example, providing centralized hosting services or for performing direct marketing activities such as calls or emailing, such service providers often qualify as a data processor. If so, the data transferring and the data receiving (processing) entity must enter into a data processor agreement, which must meet all requirements of Section 11 of the Federal Data Protection Act ("BDSG"), or, after the GDPR comes into force, Art. 28 GDPR. Companies should review carefully whether a proposed data processing agreement meets these requirements, as they are fairly burdensome. In particular, U.S. service providers are often not familiar with them. However, both a missing agreement and an agreement that is not fully compliant can trigger substantial fines. In case of data transfers to other entities that do not qualify as a data processor, one needs to check whether the transfer is permissible based on consent of the data subjects, the requirements for the performance of a contract or otherwise permissible based on a balancing of interest test. Please be aware that German supervisory authorities tend to apply strict scrutiny when assessing whether a data transfer is permissible. Even though under the GDPR, data transfers to other group affiliates will be facilitated, a free flow of personal data between group entities is not permissible. Each data transfer must serve a specific legitimate interest.

Passing the Second Step – EU/U.S. Privacy Shield or Standard Contractual Clauses?

With the recent public discussion around the fall of the EU/U.S. Safe Harbor Program in 2015, it became widely known that the United States is generally not approved as providing for an adequate data protection standard in terms of EU data privacy laws. However, in 2016, the EU Commission and the U.S. Department of Commerce quickly found a successor to the EU/U.S. Safe Harbor Program which is now called the EU/U.S. Privacy Shield (see: https://www.privacyshield.gov/welcome).

Companies transferring personal data to the United States have various options for passing the second step:

EU/U.S. Privacy Shield

If a U.S. company has signed up for the program with the U.S. Department of Commerce, it is deemed as being located in a country that is approved as providing an adequate data protection standard. As a result, the transfer of personal data to such a company, for example, a new U.S. affiliate or vendor, only has to meet the requirements for intra-EU data transfers (see requirements of the first step above). However, the U.S. company must adhere to certain principles on the processing of personal data as specified by the EU/U.S. Privacy Shield, and any breach can lead to significant enforcement actions by U.S. regulatory bodies and to the suspension of data transfers from the EU.

In practice, it is often favorable to rely on the EU/U.S. Privacy Shield if data is transferred to a longer chain of various data processors. However, investors should be aware that the EU/U.S. Privacy Shield is currently legally and politically challenged. It may well be that the shield will soon be either modified or declared void by the European Court of Justice.

Standard Contractual Clauses

Another option to meet the second step as outlined above is to enter into the so-called Standard Contractual Clauses (also called Model Clauses) as approved by the EU Commission (http://ec.europa.eu/justice/data-protection/international-transfers/transfer/index_en.htm). Once both the data exporting as well as the data importing entity have signed the appropriate Standard Contractual Clauses, any data transferred to the United States is deemed as being protected by appropriate contractual safeguards. The advantage of these Standard Contractual Clauses is that they are standard and must not be modified. This generally facilitates the negotiations with the U.S. counterpart. However, in order to meet the first step, the company must ensure that the Standard Contractual Clauses are amended so that they meet, for example, the requirements of Section 11 BDSG. While no additional notification or approval is required in Germany, some other EU Member States require notification or the approval of data transfers based on the Standard Contractual Clauses. Fortunately, the GDPR will end these requirements and thus greatly facilitate the use of the Standard Contractual Clauses.

Implications for Data Transfers to a U.S. Affiliate

As mentioned before, German data privacy law and the new GDPR do not permit a free flow of data between affiliated companies. German companies should thus carefully consider which data it needs in the United States and then, based on that consideration, enter into the appropriate data transfer/processing agreement in order to ensure that both steps of the two-step tests are passed. For such intragroup data transfers, the Standard Contractual Clauses are most often the best option to work with.

Using U.S. Service Providers

Even though many U.S. service providers, in particular, cloud services providers, offer attractive services for competitive prices, the engagement of such a service provider with data centers in the United States should be carefully planned.

As outlined above, any German technology company that wants to engage such service providers with the processing of EU personal data must enter into fairly complex data processing agreements. In addition, German supervisory authorities often require more than what is the generally accepted standard in the EU. For example, all requirements under Section 11 BDSG (see above) have to be met, or specific requirements are set for cloud services (see *Orientierungshilfe Cloud Computing* at https://www.datenschutz-bayern.de/technik/orient/oh_cloud.pdf or the BSI Cloud Computing Compliance Controls Catalogue C5) which are fairly onerous and may thus (at least initially) not be accepted by U.S. providers.

Further, if German or U.S. entities provide services to EU customers, the data processing agreements entered into with the EU customers need to be carefully drafted as most of their obligations need to be passed down to the U.S. providers who are often reluctant to agree to agreements that deviate from their own standard data processing agreements. It is thus imperative to first conduct a careful review of the U.S. providers' data processing agreements and their security standards for compliance with EU and other internationally accepted standards before any commercial decision is made. In our experience, the willingness of adjusting data processing agreements to EU customer needs significantly decreases once the main master services agreement is signed. In addition, one needs to understand if and how the service provider's contractual setup conforms to the standards the German company offers its EU customers.

The following guidance may help tackle these issues:

- Do not sign any commercial contract before you have ensured that the vendor is aware of EU data privacy requirements and is willing to adjust its data processing agreements to fit these requirements and your needs.
- Ask the U.S. vendor for internationally accepted certificates on data security and, if possible, for compliance with international/German cloud standards such as ISO 27018 or BSI C5.
- Understand whether the entire chain of sub processors is able/willing to comply with the data processing agreements you need for the EU data privacy compliance.

3 Trade Secrets — Why it Matters so much in the United States

What is a Trade Secret?

A trade secret is confidential information of a commercial nature from which the holder derives an economic benefit. A trade secret may be a secret device, formula or process or customer lists or other business, financial or technological confidential information. Unlike patents, which require the disclosure of certain information, demand registration and respective fees from time to time, and will "only" offer protection for a certain period of time, owners benefit from trade secrets both in convenience as well as in a financial way: trade secrets are not limited in time, but, are protected ipso jure for as long as they remain confidential and do not need to be registered upon fees.

Nevertheless, it is often inevitable and necessary to disclose information to certain employees and to licensees during the course of business. Although absolute confidentiality is not practicable, owners of trade secrets must undertake all reasonable precautions against misappropriation risks by these persons to benefit from protection under trade secrets law. Although threats arise mostly from those who are granted access to trade secrets (in particular employees and licensees), third parties who illegally access trade secrets (or parts of it in an effort to engage in "reverse engineering") also pose a risk.

Stay on the Cutting Edge with the "*Trade Secrets Watch*"

Orrick's blog "Trade Secrets Watch" offers the latest trade secret news and analysis from the U.S. and across the globe. It covers recent cases and proposed legislation, verdicts and settlements, practice tips, upcoming events, and other interesting trade secret tidbits. *Trade Secrets Watch* has established itself as one of the leading trade secret blogs since it launched in May 2013, with reprints and discussion of our blog posts in media such as *Bloomberg*, *Corporate Counsel*, *Law360*, and *The IP Litigator*.

Learn more at ***http://blogs.orrick.com/trade-secrets-watch/.***

How are Trade Secrets Protected and Enforced?

In the United States, trade secrets are protected by state law, with many states observing the guidance of the United States Uniform Trade Secrets Act ("UTSA"). Violations of these rules will entitle the owner to bring forward civil lawsuits before state courts against the "thief". In addition, certain "thefts" of trade secrets may be punishable under criminal law, in particular the U.S. Economic Espionage Act.

The newly enacted United States Defendant Trade Secrets Act of May 2016 ("DTSA") further opened the doors of federal courts to trade secrets litigants and augmented existing protections. The U.S. Senate cited the mounting cybersecurity risks as the driving force behind the DTSA, as protection became increasingly difficult given the ever-evolving technological advancements. As state law resulted in state-to-state variation on a number of important issues, the DTSA is a step in the direction of homogeneity. Now a trade secret owner may file a petition in a Federal District Court alleging claims under both the DTSA and, if applicable, the UTSA as codified under state law. To satisfy the scope of DTSA's "interstate commerce" jurisdiction requirement is simple: any trade secret information related to a product or service that is sold or offered via internet is likely to fulfill the premise.

The remedies set forth in the DTSA are largely adopted from the UTSA. The civil seizure remedy is, however, new. Under extraordinary circumstances, the plaintiff may obtain an order on an ex parte basis directing a federal marshal to seize from the defendant the allegedly misappropriated trade secret. This might be the case when the applicant will suffer "immediate and irreparable injury" in a way that other forms of extraordinary relief, such as temporary restraining orders, would not adequately address. This remedy has long been available to trademark infringement litigants under the Lanham Act, which may now provide for guidance in jurisprudence.

This broadened arsenal of far-reaching remedies makes managing trade secret litigation risks an ever more important topic for every technology company active in the United States, and we recommend obtaining legal advice early on to establish adequate compliance systems.

The DTSA is also relevant for technology companies for another reason, as it provides guidance for employer-employee cases.

The DTSA now clearly answers the question of employee mobility, which has been subject to contested litigation under the UTSA. Contrary to the "inevitable disclosure doctrine," the court may not order an injunction that prevents a former employee from entering into a new employee relationship based on a showing that the former employee's knowledge of the employer's proprietary information is so comprehensive that the employer's trade secrets would inevitably be disclosed and used in the course of the former employee's new employment. Also, the DTSA must not conflict with existing state law that prohibits restraints on lawful profession, trade or business.

In addition, whistleblower immunity provisions provide for criminal and civil liability to any person who discloses a trade secret to a federal, state or local government official solely for the purpose of reporting or investigating a (mere) suspected violation of law (especially criminal statute, environmental regulation or labor standard). In case the employer retaliates against the employee, the DTSA permits the employee to disclose the employer's trade secret to his attorney and use it in any subsequent retaliation suit.

In addition, employers must comply with the notice requirement regarding this immunity in employment agreements entered into after the DTSA's enactment in May 2016.

Otherwise employers are precluded from seeking recovery of attorneys' fees or other exemplary damages, which are granted by the DTSA to owners of trade secrets under certain circumstances. As a result, it is of utmost importance for employers to comply with the notice requirement.

What must Owners of Trade Secrets Do?

Owners of trade secrets must take affirmative actions and use reasonable efforts to protect their confidential information and benefit from the aforementioned trade secrets laws. Once trade secret information is disclosed – whether intentionally or inadvertently – it ceases to be protected under trade secret law.

But what does that mean in practice? What is "reasonable?" The laws don't tell us. Like the "reasonable person" standard in negligence, courts are supposed to decide each case in the context of its unique facts. That said, looking back at several decades of decisions, we can get a good sense of the principles at work and also how they may be shifting as the business environment becomes more digital and more global.

The good news is that the standard is flexible, taking into account the value of the information, the risk of loss or contamination, and the cost (in money and effort) of measures to reduce those risks. For most businesses, this means simply taking a close look at what drives your competitive advantage and then applying ordinary risk management analysis to define the broad outlines of a protection plan. In practical terms, this can lead to a variety of specific actions, including the basic ones you find on a lot of checklists with items like confidentiality agreements, IT system access controls, staff rules and training, and facilities security.

So if you're following one of those checklists, you should be fine, right? Not necessarily. Although judges historically have been forgiving of less-than-robust security measures, they now seem to be paying much closer attention to this issue and have even thrown out claims without trial where the trade secret owner has been sloppy in its practices. Naturally, as the risks increase, the market responds with tools and systems to prevent cyberattacks, or at least discover them early and frame an appropriate response. And government agencies, most notably the National Institute of Standards and Technology, have suggested frameworks for managing cybersecurity risks. It's not hard to imagine that these voluntary processes may, over time, be interpreted by courts as best practices, and even as minimum standards of conduct.

Overall, any owner of a trade secret should obtain proper advice on how to protect it early on. Owners will have to implement organization and technical security measures to limit access to internal information as well as apply appropriate trade secret and information security policies, potentially even with perpetual obligations toward employees. Finally, the notice of immunity under the DTSA is a "must have" in employment agreements.

4 Employee Participation Programs: United States vs. Germany

When German technology companies want to hire qualified talents in the United States, they are required to offer adequate compensation systems. In the United States this means some form of an employee participation program (be it equity-based or virtual). It should be noted that especially in Silicon Valley, not only employees but also many advisors will often request stock options and other equity interests, or, although rather uncommon in the United States, virtual shares.

Equity-Based ESOPs in the United States and VSOPs in Germany

In the United States, employee participation programs are often set up as "real", *i.e.* equity-based, employee stock option programs ("ESOP"). A stock option gives a beneficiary the right to buy stock at a specified exercise price (or "strike price"). The beneficiary pays the exercise price and then receives the company stock. Under U.S. tax law, there are two types of stock options: (i) "incentive stock options" or "ISOs," and (ii) "nonqualified stock options." ISOs must meet certain requirements to qualify for tax benefits to the employee. Nonqualified stock options can have more flexible terms but do not deliver as many tax benefits to beneficiaries. With each type of option, there is generally no tax event on the date the option is granted, for either the company or the beneficiary. The treatment of the two types of options differs at the time of exercise of the option, and also during the period that the beneficiary holds the stock after it is transferred to her.

In Germany, similar equity-based ESOPs are rather unusual for a German technology company that has been set up as a GmbH. The main problems with an equity-based ESOP are:

- Having many beneficiaries in the company's cap table is problematic because in a German GmbH, every shareholder has certain unalienable rights, including information rights or the right to challenge resolutions adopted by the shareholders' meeting.
- Shares and options in a German GmbH are not freely transferable as such transfers require notarization in front of a notary in Germany and, in most cases, a consent by the shareholders' meeting.

Thus, virtual employee participation programs ("VSOP") are much more frequent in Germany. VSOPs are designed to operate in a manner similar to an equity-based ESOP, but without delivery of actual shares or options. Rather, the beneficiaries obtain contractual claims (so-called "virtual shares" or "virtual options") against the issuing company for a cash payment in case of a liquidity event if the liquidity event and other circumstances satisfy the terms of the plan. As with an actual stock option, the value of the cash-out for the virtual option would be based on the liquidity event value of the company's stock.

VSOPs can potentially deliver similar value to beneficiaries as equity-based ESOPs without invoking the limitations associated with such ESOPs.

German VSOPs for U.S. Beneficiaries

To accommodate the expectation of their U.S. employees and advisors, German technology companies have the following options:

- If they flip into a U.S. company (see Chapter A.2 above), they can set up a typical U.S.-style ESOP on the level of the new U.S. holding company; or
- They can try to make an existing German market VSOP available to beneficiaries in the United States.

In fact, there are a number of advantages to using a virtual stock option program in the United States. First, the issuing company is not limited by tax regulations in terms of which service providers may be granted stock options. Please note that to address issues under the "Section 409A tax regime" under U.S. law, a stock option typically can be granted only to employees and service providers of the company and certain subsidiaries. With virtual stock option grants, those limitations do not apply and the company is able to grant stock options to service providers on the basis of its business goals. With virtual options, the company is also not required to grant a virtual option that has a strike price that is at least equal to the "fair market value" of the stock, giving it more flexibility to set an appropriate strike price than it has with real stock options.

However, German technology companies must be aware that in many cases typical German VSOPs are not compliant with U.S. law, in particular U.S. tax law. Applying them without proper amendment for beneficiaries that are subject to U.S. taxation can result in material tax liabilities and even criminal liability for the beneficiary.

In the United States VSOPs must comply with the "Section 409A rules," or must qualify for an exemption from those rules. The "Section 409A rules" can result in restrictions on the payout triggers, and can also limit flexibility to change the plan's terms in the future. Thus, it is advisable to have the German VSOP being modified by a special supplement for U.S. beneficiaries. The U.S. supplement will be annexed to the VSOP, and that supplement will prevail in case of any conflicts with the main body of the German VSOP for matters that involve U.S. beneficiaries.

Here are a few examples for provisions that are typical in German VSOPs and that would need to be amended in the U.S. supplement when extending the German VSOP to beneficiaries subject to U.S. taxation:

- German VSOPs often provide for a suspension of the vesting period in case of a maternity/paternity leave, sabbatical, long-time illness, etc. For U.S. beneficiaries such an expansion may only apply to the extent permitted by applicable U.S. federal, state or local law with respect to the applicable leave or suspension of employment.

- Typical German VSOP provisions regarding the definition of a "good leaver" and a "bad leaver" do not fit with U.S. employment concepts. Thus, such good leaver and bad leaver definitions must be amended as well, *e.g.*, in many cases with respect to the definition of "cause" for the termination of an employment contract that would render a U.S. beneficiary a "bad leaver".

- Typical German VSOPs with respect to the payout of the beneficiary's claims in case of a liquidity event need to be amended as well. For example, a U.S. participant may only benefit from payments relating to deferred payments, escrow amounts or earn-outs agreed upon in the contracts underlying the liquidity event, which are payable pursuant to payment and timing structures that comply with rigid U.S. tax laws under the Section 409A regime.

5 Managing Litigation Risks

When contemplating entrance to the U.S. market, newcomers are often worried about the increased liability exposure. The litigation risk in the United States is indeed significantly higher than in many other countries. Customers and employees are more likely to resort to litigation than their German peers. Then there are also the infamous "patent trolls", whose business model consists in buying up patents and then seeking license fees from companies whom they claim are infringing those patents.

There are several factors contributing to the much higher litigation risks in the U.S. market:

- One of the main reasons is that filing lawsuits is rather inexpensive. Court filing fees are comparatively low and attorneys are often willing to agree to contingency fees, where the fees are payable only if there is a favorable result for the plaintiff. The "loser pays" rule does not apply in U.S. litigation, so each party typically pays its own attorneys' fees and legal costs regardless of which party prevails. Consequently, as plaintiffs do not bear the risk of paying attorney's fees and legal costs of the defendant, the hurdle for potential plaintiffs to assert claims is pretty low.

- U.S. litigation allows for a very liberal pretrial discovery. During this rather early phase of the litigation, the parties have to make available to the other side all evidence in their control that may be relevant for the outcome of the case, including evidence which is detrimental to the disclosing party's case – something that is unthinkable in civil law jurisdictions such as Germany. Discovery, and particularly e-Discovery, is very burdensome; sometimes thousands of documents are exchanged. The time and cost expenditure associated with pre-trial discovery will make many defendants accept a (cheaper) settlement even when faced with a weak claim.

- Where the case is tried by a jury of lay people (instead of trained professional judges) – a right granted to all litigants by the U.S. constitution – the outcome of the case is somewhat more unpredictable as is the amount of damage that is potentially awarded to the plaintiff. This holds particularly true for product liability cases.

- Another factor that makes U.S. litigation more risky is the possibility of "class actions". This special instrument allows suing a defendant on behalf of a great number of persons (for instance customers) at the same time, who claim to have been harmed in the same or in a similar way. This instrument is particularly helpful for plaintiffs with small claims who would not have litigated individually.

- Defendants in the United States also face the risk of being ordered to pay "punitive damages", which might be substantially higher compared to granted damages in civil law jurisdictions such as Germany. Punitive damages are widely applied in the field of product liability. They go beyond the compensation of actual (material or immaterial) losses and aim at punishing the defendant as well as setting a deterrent example to other individuals or companies.

Mitigation Tools

In order to reduce litigation risk, participants in the U.S. market should consider, *inter alia*, the following strategies:

Corporate Structuring of the Business: It is not advisable to operate in the United States through a U.S. branch of the German technology company, but rather to set up a U.S. corporation. The use of a branch directly subjects the entire assets of the German technology company to U.S. liability risks, while a separate U.S. corporation offers a liability shield. Even when doing a Flip of the German company into a U.S. company, in many cases, it is also worth considering setting up a second U.S. corporation as an operational subsidiary of the new U.S. holding company to shield the holding company's shares in the German technology company from U.S. liability risks.

How to Reduce the Risk of *"Piercing the Corporate Veil"*

As a general rule, a U.S. corporation shields its shareholders from liability for the corporation's actions and omissions. However, there are certain exceptions. Most importantly, under U.S. law a court will *"pierce the corporate veil"* and hold a parent company liable for the actions of the corporation, if the parent exercises so much control over the subsidiary that the latter is a *"mere instrumentality"* of the parent. Hence, particular importance should be paid to ensuring that the subsidiary is sufficiently independent. A selection of factors that should be considered include:

- The subsidiary is adequately capitalized.
- Parent and subsidiary comply with corporate formalities.
- The subsidiary exercises business discretion.
- There is little or no overlap of officers or directors of parent and subsidiary.
- The parent deals with the subsidiary at arm's length.
- Property and financials of parent and subsidiary are clearly separated.

Contracts: U.S. contracts tend to be much longer and more detailed than contracts for similar purposes in the German market. Advised by qualified legal counsel, companies go to great lengths to draft their contracts in a tailored way to minimize litigation risks. In particular, all contracts should clearly describe service and performance obligations, and they should specify limitations of liability.

Compliance: It is advisable to establish a dedicated compliance function. Companies should have at least one compliance officer responsible for ensuring compliance with contracts, laws and regulations, in particular regarding the areas of tax and regulatory issues.

Insurance: It is absolutely crucial to carefully review whether the company's existing insurance protection is adequate for the litigation risks in the U.S. market and, where needed, to obtain additional coverage. In addition, U.S. regulations may require certain mandatory insurance policies (such as workers compensation insurance for employees), other policies might be required by U.S. contractual counterparties (such as professional liability insurance, certain kinds of automobile coverage, etc.). Other insurance policies might not be required by law or contract but are nevertheless highly recommended, in particular adequate D&O insurance coverage should be obtained in almost all cases. Depending on the company's business model an IP liability insurance or a policy against the fallouts of a cybersecurity breach might also be good ideas.

Cyber Insurance – A new Coverage to Enhance IT Security Posture

Cyber insurance has reached a tipping point. The rising costs faced by data breach victims, which can exceed $100 million for the largest breaches, have spurred an increasing number of companies across industries to turn to cyber insurance in an effort to transfer at least some of those costs to an insurer. But cyber insurance is still relatively new, at least as a mass-market insurance product, and it is evolving quickly, although not as quickly as the threat itself. The policies are complex and not standardized, and courts have yet to provide any guidance about what will be covered and what will not. This state of affairs leaves many companies that have or are considering buying cyber insurance uncertain – not only whether they will be a victim of a data breach but also whether insurance will provide them with the coverage they need if they do become a victim.

For a cutting edge overview of this rapidly evolving field and the key coverage and exclusion battlegrounds see our article ***"Cyber Insurance: An Overview of an Evolving Coverage"*** *at our blog* ***"Trust Anchor – Current Trends in Cyber Security, Data Privacy and Regulatory Compliance"*** *at: http://blogs.orrick.com/trustanchor/.*

Pro-Active Management and an Awareness Culture: Companies must educate their leadership teams and install adequate monitoring and reporting processes to identify potential problems early on, especially in HR matters, which should always be handled sensitively. In order to avoid punitive damages in product liability cases, which presuppose an intentional or exceptional gross negligent behavior, it is important to watch for indications for product, construction and instruction errors and to take timely measures like recalls.

C. Our International Platform for Technology Companies

Dedicated to the needs of technology companies and their investors

With our dedicated and full-service tech practice we provide business-focused advice to companies at all stages from incorporation to the exit.

Our current global client portfolio includes more than **1,600** growth technology companies and start-ups. Our clients include multinational technology companies as well as newer entrants.

Oracle Microsoft NVIDIA Intel Cisco Pinterest Stripe 23andme eHarmony Quora SoFi Betterment Planet Labs

Recognized for Excellence

Our tech lawyers lead the market. Don't take our word for it:

__Law360__ named our team one of four Technology Groups of the Year globally for the past two years, citing the scope of our technology representation, from executing financings of later-stage companies to winning high-stakes litigation.

__The American Lawyer__ selected us as IP Litigation Department of the Year for 2016 for our work in the technology sector.

And __Recorder__ named us Employment Department of the Year for the third time for our wins on behalf of Kleiner Perkins and other tech leaders.

Tech Group of the Year
2X

Law360

Leader in Venture Capital and Corporate Practice

Legal 500

Most Active VC law firm in Europe
for 2016 and Q1 2017
PitchBook

Legal Innovation

We value innovation as much as our clients do:

We are the legal advisor to __Stripe Atlas__ which strives to give entrepreneurs access to the basic building blocks for startin a global internet business.

In Paris, we're teaming up with __Partech Ventures__ on "Europe Made Easy," a new service to help international tech businesses enter the European market.

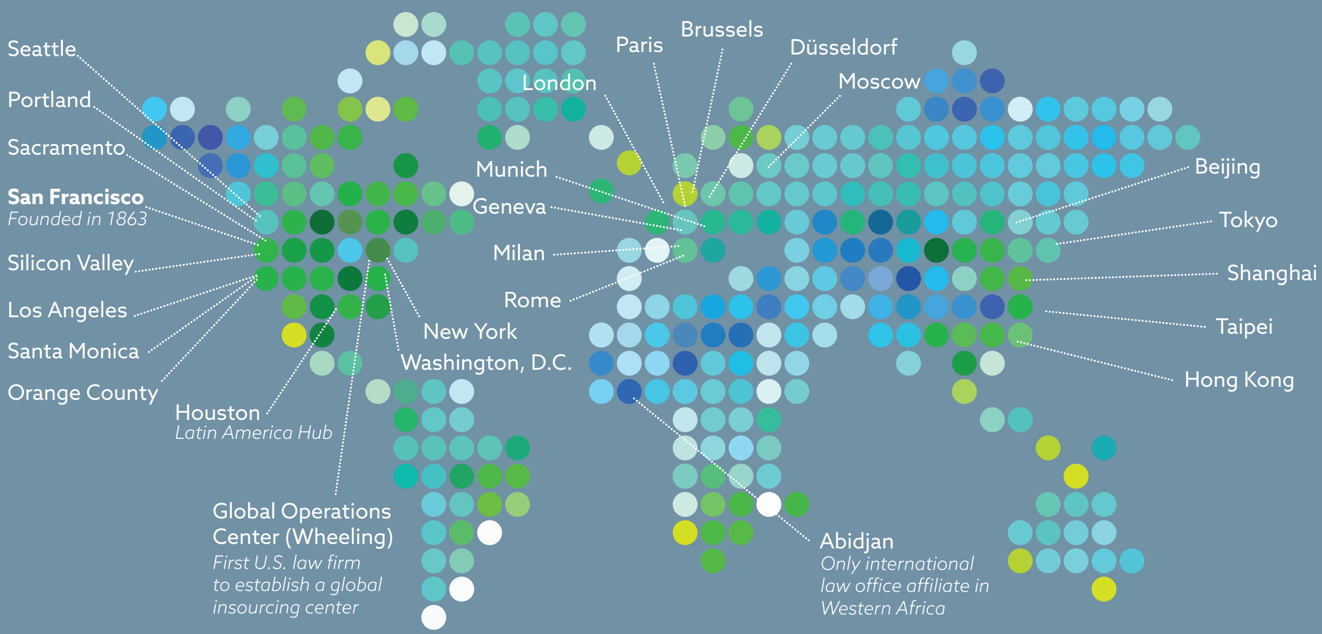
When __Y Combinator__ created its new form of early start-up financing known as Simple Agreements for Future Equity (SAFEs), we helped implement it with many of our clients. With SAFE Y-Combinator created a more flexible and efficient alternative to convertible notes used in capital raising that has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

__What's next?__ As the leading global tech firm, we are committed to investing in all these areas and the next generation of issues that our clients need to consider.

A truly global platform:

To compete in today's market, every company must play in the tech space. Orrick has built a platform to help businesses adapt and thrive in the digital landscape. Because the tech sector is borderless, so are we. Our tech lawyers practice in 25 markets worldwide. We offer a comprehensive global platform for the tech community — from the most innovative disruptors to multinational leaders. Financing, M&A, IP, Litigation, Compliance and Policy — we've got you covered.

As the leading global tech firm, Orrick teams are focused on developing solutions for the tech market of today and tomorrow.



We advise tech companies at all stages:

8 of the 10 largest Silicon Valley / SF Bay Area Companies by Market Capitalization

≈ **20%** of all **$1 Billion+ Unicorns** in the U.S. Market (either company or investor side)

6 of the **Fortune 10** TMT Companies

In 2016 alone, we advised on **330+** venture financings with a combined value of more than **$5 billion** in **35** countries

Nest
US$3.2 billion acquisition by Google
Seller's Counsel

Yammer
US$1.2 billion acquisition by Microsoft Corporation
Seller's Counsel

Instagram
US$1 billion acquisition by Facebook (U.S.)
Seller's Counsel

Cruise
Over US$1 billion acquisition by General Motors
Seller's Counsel

TOA Technologies
Acquisition by Oracle (terms not disclosed)
Seller's Counsel

AVG
US$1.3 billion acquisition by Avast
Seller's Counsel

Apple
Acquisition of WiFiSlam and Siri (terms not disclosed)
Acquiror's Counsel

Pinterest
Acquisitions of Kosei (terms not disclosed)
Acquiror's Counsel

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D. About the Authors

About the Authors

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John is a member of Orrick's Board of Directors and Orrick's Technology Companies Group. He leads the international Technology Companies Group connecting Silicon Valley with Europe and Asia. John focuses his practice on advising emerging companies and investors, and represents both public and private high-tech companies in many areas, including corporate and securities law, venture capital financings, mergers and acquisitions, public offerings, public company representation, and technology licensing. He is recognized for his work with Y Combinator in helping to create the SAFE (Simple Agreement For Equity).

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Sven is a member of the European Technology Companies Group specializing in complex cross-border mergers and acquisitions, private equity and venture capital investments. His dual background in business and law, entrepreneurial zeal and the experience of more than 100 M&A transactions and financing rounds give him a uniquely broad perspective and inspire creativity to find the best strategic and commercially viable solution for his clients. Sven routinely volunteers his time with entrepreneur groups and frequently lectures at the WHU Otto Beisheim School of Management.

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