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Venture Capital Investments

Beat Schwarz and Franz Schubiger¹

Characteristics of a venture capital transaction

Swiss law neither defines nor provides a specific set of rules for venture capital (VC) investments. However, the nature of VC transactions as direct equity investments provides for some particular characteristics that are not (or less) relevant in other M&A transactions and must be addressed when negotiating and entering into a deal to avoid interference with mandatory Swiss law.

The same as for private equity, VC investments are investments in shares of non-listed companies. While private equity investors typically aim for a buyout, in which they obtain 100 per cent control over a usually already matured company with a stable business track record, VC investors typically aim to invest, alongside other strategic or financial investors, to provide funding to, and to obtain a minority equity stake in, fast-developing and growing start-up and innovative companies. Such direct equity investments involve, by their very nature and owing to the investment in equity securities, significant risks for the investor, but also provide for high growth and respective profit and return on investment potential.

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The investment amount of a VC investment can vary significantly and, typically, an emerging growth company sees different investment stages during its early lifetime. While the initial investors, besides founders, in initial funding rounds often consist of wealthy private individuals (business angels) and family and friends (often referred to as seed stage and early stage financing), VC investors and funds or strategic investors (such as corporates or corporate VC funds) typically become more active in later rounds (eg, starting in a series A or B round) in order to provide funding for growth and expansion (later stage financing), often ranging up to multi-million investments. Sometimes, existing investors also participate beside new investors in subsequent financing rounds and thereby increase their investment.

Market overview²

2022 market trends

Despite strong headwinds caused by inflation, geopolitical uncertainties and supply chain issues, the Swiss start-up scene continued its growth path in 2022. While the number of funding rounds grew slower than in previous years (383 rounds, up only 7.9 per cent compared with 2021), the amount of invested capital once again increased significantly and reached a record 3.969 billion Swiss francs (up 29.7 per cent compared with 2021). Key growth was recorded in the cleantech (thanks to the Climeworks 600 million Swiss francs mega round), the ICT and the fintech sectors, where the increase in invested capital was the highest (more than 2 billion Swiss francs, up 72 per cent compared with 2021).

Valuations of individual companies also reached new dimensions for Switzerland, with insurtech Wefox valued at 4.4 billion Swiss francs in its 2022 financing round of 392 million Swiss francs and ICT company SonarSource reaching 4.6 billion Swiss francs in its 394 million Swiss francs round. Notable

² The stated 2022 data are extracted from the 2023 VC report published by <https://www.startupticker.ch> and the Swiss Private Equity & Corporate Finance Association (SECA).



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investment rounds exceeding 100 million Swiss francs were further conducted by Scandit and SEBA Bank at respectively 138 and 110 million Swiss francs.

Given the market conditions, less good news has to be reported on the IPO front. With only five IPOs from Switzerland-linked start-ups, 2022 resulted in a rather unspectacular year compared with the 11 IPOs in 2021. Noteworthy in that regard is XLife Sciences, a biotech start-up that was the first company to go public on Sparks, the new small and medium-sized company segment of the Swiss stock exchange, SIX. With respect to trade sales, as in 2021 with around 50 transactions, 2022 marked a very strong year with 60 trade sales of Swiss start-ups/emerging growth companies, despite a slowdown in the second half of 2022. Most of these exits occurred in the ICT sector, followed by fintech and cleantech.

With investments and a strongly growing ecosystem, VC funds in Switzerland are also on the rise. Fifty-five Swiss VC funds are already active, offering institutional investors a wider choice than in previous years. Geographically, the most activity can be reported from Zurich, with venture capital investments of more than 2 million Swiss francs (invested capital increased by 64.8 per cent).

The basis of a strong Swiss VC ecosystem

In the rankings of the World Intellectual Property Organization, the World Economic Forum's Global Competitiveness Report and the European Innovation Scoreboard, Switzerland is regularly top-ranked for its innovation, competitiveness and education, not only in terms of university education but also for its formation on the job as an alternative, profession-focused route to university education raising a well-educated workforce with relevant know-how in technical and other relevant sectors, which also benefits the start-up and VC ecosystem. To name just a few, the polytechnic universities in Zurich (ETH) and Lausanne (EPFL), as well as other world-leading research institutes such as CERN in Geneva or the Paul Scherrer Institute (PSI) located in the canton of Aargau, are very important in driving innovation, and start-ups are often located and closely connected to those universities and institutions. Many other cities and regions in Switzerland have seen an increase in successful start-up and VC activities. For example, Basel, owing to its already very strong



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pharmaceutical and biotech industry (with multinationals such as Novartis and Roche), also hosts a high number of start-up companies in the biotech sector.

The Swiss VC sector benefits not only from innovative research institutions and a generally tax-friendly environment, but also from a well-educated and driven workforce, for which a venture in a start-up is nowadays often preferred over corporate employment. Also, the number of investors capable of leading large multi-million VC rounds has increased significantly over recent years. In the past five years alone, the market has seen the entry of a considerable number of VC funds backed by experienced professional entrepreneurs and investors. Further, digitalisation and other trends that challenge established business models have caused many corporations to initiate their own VC activities or to cooperate, buy or become a (lead) investor in start-ups in order to benefit and learn from technology, experience and new approaches that help to adjust established business models according to market needs.

These factors caused a significant boost to the Swiss VC ecosystem in past years, allowing for more professionalisation and institutionalisation in venture capital investments. However, it can still be observed that large (and later-stage) investments are regularly led by foreign lead investors. This may also create a certain risk that the start-up shifts operational activities abroad. However, it is noteworthy that exactly this combination of attractive and innovative Swiss start-ups with the availability of foreign funds from international financial or strategic investors has caused so many success stories and enabled promising Swiss ventures to successfully expand globally over the past few years.

Therefore, this chapter focuses on the perspective of the foreign (lead) investor (eg, a VC fund, a corporate VC or corporates) in later-stage venture capital investments with the aim of giving some insights into the particularities of the Swiss legal framework applicable to the transaction.

Legal and tax framework in general

The legal framework in Switzerland is transaction-friendly. Except for specific sectors – such as banks, insurers or electricity providers or investments in real estate – there are no notification or approval requirements or restrictions on foreign investment in Switzerland. Existing merger control or sector-related notification or approval requirements are usually not relevant in a venture



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capital investment. Moreover, Swiss law permits the reflection of the usual deal parameters negotiated by the parties for the full range of venture capital investments, although the implementation of such deal parameters may vary in certain aspects from the Anglo-Saxon approach, because some common features of a venture capital transaction may interfere with Swiss corporate law. However, there is flexibility under Swiss contract law to provide for the usual preference rights (some of which may also be reflected on a corporate level with preferred shares) that a later-stage (lead) investor in a venture capital transaction usually asks for.

From a tax law perspective, an investor needs to take into account that Swiss tax law does not provide for specific tax incentive schemes for institutional venture capital investors. A Swiss resident venture capital investor, however, may benefit from the general participation exemption. Under the general participation exemption, capital gains from the sale of a qualifying participation are virtually tax-free. A qualified participation is an equity investment that represents at least 10 per cent of the equity of a company and has been held by the investor for at least one year prior to being sold. Further, the participation exemption applies to dividends received from equity investments of at least 10 per cent or equity investments worth at least 1 million Swiss francs. Switzerland levies a dividend withholding tax at the statutory rate of 35 per cent. While Swiss tax resident investors are generally entitled to full relief, foreign investors may only claim relief based on a tax treaty. Switzerland has a very wide network of tax treaties, which generally provide for relief from Swiss dividend withholding tax if the investor is tax resident in the relevant treaty state and the beneficial owner of the dividends. For qualifying participations, a number of tax treaties provide for full relief from Swiss dividend withholding tax. For shareholdings below 10 per cent, a residual treaty rate of usually 15 per cent applies.

Typical direct equity investment versus alternative VC deal structures (such as convertible loans and venture debt)

In later stage VC financing rounds of Swiss start-ups (eg, series C, D or E rounds), the parties usually pursue a direct equity investment approach and structure, whereby the new investor(s) and sometimes also existing shareholders agree



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to invest and subscribe for new shares (eg, preferred shares) in the company against payment of the investment amount. The company and the existing shareholders need to ensure that certain resolutions are passed and actions taken in order to implement the investment through a capital increase.

In practice, alternative VC deal structures have emerged and become common in Switzerland, in particular, as interim solutions or in distressed financing situations.

Regularly, convertible loans are used in order to bridge funding gaps between equity financing rounds. In such debt financings, existing and/or new VC investors provide – often unsecured, sometimes subordinated – debt financing to the company, whereby the terms need to be aligned with the existing arrangements (eg, shareholders' agreement) and have to respect the statutory and contractual rights of existing shareholders. By their legal nature, these VC financings provide for or allow for a conversion of the debt into equity (ie, mandatory or voluntary conversion) when certain triggers are met (eg, qualified equity financing round, change of control or upon maturity) or other requirements are fulfilled (eg, non-qualified equity financing round).

Further, venture debt provided by banks or non-banks may be an option for a company to complement the equity funding (eg, as bridge financing or to finance capital expenditure, specific projects or acquisitions). For example, VC funds or funds with a special investment focus may be willing to provide debt financing in a venture debt transaction, provided that the company has a solid investor base and prospects for further equity financings (eg, also as primary source for repayment of the loan). In a venture debt transaction, a debt financing, for example in the form of a loan agreement (disbursed in different tranches; whether secured or not), is combined with equity-linked features (such as conversion rights for individual loan tranches or warrants for the acquisition of additional shares as equity kicker). In such hybrid structures, the equity investment (if any) itself is achieved through a (partial) conversion of the debt into equity and/or the exercise of warrants later on (eg, in a subsequent financing round or upon maturity of loan tranches).

The following discussion and explanations focus on the direct equity investment approach and its mechanics.



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VC transaction sequence and key documents

In terms of transaction phases, a typical VC transaction does not largely deviate from other (private) M&A transactions and can be divided into three phases:

- a preparation phase;
- a contract negotiation phase; and
- signing and completion of the transaction.

After having prepared the due diligence process and a business plan, which will serve as a basis for the valuation that defines the subscription price per share, the founders and existing (lead) investors and other shareholders engage in negotiations with potential new investors. In the negotiation phase, the interested VC investor usually conducts a due diligence review of the Swiss company, and the terms of the investment need to be negotiated and agreed upon.

Unlike a buyout transaction (such as a sale to a PE investor or in a trade sale to a strategic purchaser), in which 100 per cent of the existing shares change hands against payment of a purchase price from the seller or sellers to the purchaser subject to a share purchase agreement, a venture capital investment round leads to an issuance of new shares by the company, which are subscribed to by the new (and often also existing) investors against payment of the investment amount in order to finance the company's operations and growth, all subject to and on the basis of an investment agreement as well as a shareholders' agreement. Usually, the company's revised articles of association, reflecting the status after implementation of the financing round, and the organisational regulations governing board matters, form an integral part of the shareholders' agreement. For these VC documents, there are widely accepted standards and templates available that generally allow the reflection of all features that are commonly used in the VC industry. For example, the Swiss Private Equity & Corporate Finance Association (SECA), a leading industry organisation, provides model sets of documents for VC financing rounds with Swiss start-up and emerging growth companies, which can serve as a starting point for crafting tailor-made solutions (www.seca.ch).



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Interplay between corporate law and contractual arrangements in VC transactions

In venture capital financing, the deal terms and related legal rights and obligations of the parties involved are laid down on the one hand in the transaction agreements (investment and shareholders' agreements) and on the other hand, they are mirrored to the extent possible on a corporate level in the articles of association and organisational regulations of the Swiss company. In order to have an elaborate and coherent framework, covering all relevant aspects beyond corporate law aspects and offering the required investment protection to investors, it is indispensable to enter into the transaction agreements.

To some extent and as in other jurisdictions, Swiss corporate law imposes certain restrictions (as outlined below) on how contractual obligations – which are fairly common in a VC context – can be entered into by the company. For example, the Swiss company cannot validly by contract commit itself to perform or to procure the performance of all required actions (eg, shareholder resolutions) necessary to increase the company's share capital and to allot the new shares, which are key items in an investment agreement for completing the investment round. Accordingly, the founders as well as other existing shareholders and investors often commit to procure that the requisite corporate actions are taken or performed.

Also, owing to mandatory Swiss corporate law restrictions, some common features in a VC investment and respective (preference) rights attributed to later-stage investors cannot be reflected in a Swiss company's charter documents (ie, the articles of association and its organisational regulations, such as sales proceeds preference or redemption features). Other than in many other M&A/PE settings, where Swiss corporate law by default assures that a controlling shareholder can in fact obtain its controlling rights by virtue of corporate law rules alone, there are limits on how investor (preference) rights common in a VC investment can be implemented and enforced by virtue of corporate law and charter documents alone. Obligations regarding the exercise of voting rights or transfer restrictions only create contractual rights and need to be enforced against the non-complying party. It is therefore also not possible to challenge the validity of a shareholder or board resolution, which has been resolved in violation of the transaction agreements. Therefore, in a typical VC set-up with many minority shareholders, from the initial investment



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until the exit, common preference rights of later-stage investors heavily depend on well-drafted and enforceable transaction agreements, such as the investment agreement as well as the shareholders' agreement, that bind and can be enforced against all shareholders in order for them to vote or instruct board members to undertake the necessary actions to comply with the transaction agreements or to ask for damages payments.

Investment approach and terms, share subscription

Overview

The terms and process of the investment and the related share subscription are agreed upon in an investment agreement between the investors, all existing shareholders (including the founders) and the company. As key elements of such financing rounds, the investor subscribes and receives newly issued shares. Hence, in the investment agreement, the main obligations of the existing shareholders are to waive their subscription rights and to perform all necessary actions to increase the company's share capital, and the investor's principal obligation is to subscribe for the newly issued shares and to pay the investment amount.

Mechanics of direct equity investment, funding approach

With regard to the terms of the investment, the investment agreement sets forth the details on the type of the newly issued shares (eg, often a series of preferred shares) and the subscription price per share referring to an underlying pre-money valuation. The capital structure of the company is usually set forth in a separate document, the cap table, which sets out the company's initial capital structure prior to the capital increase and the final capital structure after the capital increase.

The funding undertaken by the investors pursuant to the investment agreement can be structured and implemented in one single tranche at the closing (ie, one capital increase) or can be split into several tranches (eg, depending on the achievement of predefined milestones). A staggered funding approach can be a useful means for investors to monitor the progress of the company's projects and business development in accordance with the business plan and



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to mitigate investment and funding risks. However, staggered funding adds complexity and increases the transaction costs, because multiple capital increases are usually necessary.

Representations and warranties, remedies

Similar to other M&A transactions, a set of representations and warranties is typically agreed upon in an investment agreement governed by Swiss law. Besides the founders of the company, often other existing shareholders, such as family and friends of the founders, business angels or other investors that are invested in the company are requested to provide representations and warranties.

However, if these existing shareholders are not directly involved in the company's business, they may be reluctant or unable (eg, through a lack of information) to provide later-stage investors with any representations and warranties relating to the business of the company (as opposed to warranties relating to the shareholder itself, for example, capacity and share ownership).

Also, the founders in the early stages of a company may not have sufficient funds to potentially indemnify the investor in case of a misrepresentation or a breach of a representation and warranty. To address this concern, the investment agreement may foresee as a remedy an obligation of the existing shareholders to transfer shares in the company to the investor as compensation for damages (or part of the damages whereby the remainder of the damages is indemnified in cash, creating a staggered remedy concept) instead of a monetary damage payment. However, such a compensatory share transfer may not always be an appropriate compensation. In particular, in cases of substantial damages resulting from breaches of representations and warranties, the existing shareholders may be marginalised to a large extent. In general, however, VC investors are interested in keeping existing shareholders, such as founders or management shareholders, incentivised.

Therefore, in line with usual standards in Anglo-Saxon VC agreements, it is often suggested that representations and warranties are given by the Swiss company and not by the founders (or other existing shareholders), in particular, in later-stage rounds. However, in cases where the company shall be liable for breaches of representations and warranties, besides the fact that a new (lead)



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investor pays its own damage to a large extent, significant mandatory restrictions pursuant to Swiss corporate law regarding the prohibition of the repayment of paid-in share capital (article 680 paragraph 2 of the Swiss Code of Obligations (CO)) and other capital protection rules forbidding direct or hidden distributions (article 678 CO) also need to be observed.

These rules essentially lead to a situation in which a company can only compensate or indemnify new shareholders (investors) for damages up to the amount of the company's freely distributable equity (ie, the amount that would be available for dividend distributions to its shareholders). For obvious reasons, these restrictions most often effectively eliminate any reliable remedy, because early-stage companies generally do not have sufficient freely distributable equity to cover for potential liabilities. Therefore, the VC investor must carefully consider whether to require the company itself to grant representations and warranties or to insist that (some) existing shareholders have to provide representations and warranties (often subject to reasonable limitations and liability caps).

An alternative way to compensate damages resulting from misrepresentations or breaches of warranties is a compensatory capital increase, which essentially works in a similar way to an anti-dilution (down-round) protection. Under the concept of a compensatory capital increase, in the event of a breach of representations or warranties, the existing shareholders agree that the company's share capital be increased for the sole benefit of the new investor(s). In particular, the existing shareholders agree in the investment agreement on waiving their subscription rights for the new shares issued in connection with the compensatory capital increase, and the investor is granted the right to subscribe for such new shares at their nominal value, which is usually much lower than the subscription price based on the valuation of the company.

Swiss law provides the parties with a lot of flexibility in this respect as the compensatory capital increase can be combined with a cash indemnification. For example, it is often agreed that with respect to representations and warranties given by the Swiss company, the remedy is primarily a cash indemnification, and secondarily, if there is no freely distributable equity, the remedy shall be a compensatory capital increase.



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Completion of the VC transaction

The process of completion of a financing round on the basis of the investment agreement differs significantly from the completion of a share purchase agreement. In a share purchase agreement, the transfer of the shares to the buyer and payment of the purchase price usually take place simultaneously. In an investment agreement, however, owing to the particularities of the formal capital increase process, such mechanisms are not possible. According to Swiss law, the formal ordinary capital increase process requires that the shareholders' meeting first approves the capital increase. Such a resolution needs to be passed in the presence of a Swiss notary public, who has to prepare a public deed. The investor will then have to sign a subscription certificate and to pay the agreed investment amount into a blocked bank account opened in the name of the company. After the company has received the investment amount, the board of directors of the company issues a capital increase report and, once all requirements are met and documents are available, the board will proceed with certain ascertainment on and the execution of the capital increase, all to be reflected in a public deed to be drawn up by a notary public. Finally, the capital increase needs to be registered in the competent commercial register in order to become fully effective. The new shares are validly created and issued upon registration in the commercial register, which may take a few business days.

Therefore, the capital increase process in Switzerland requires the VC investor to pay the investment amount in advance before receiving the new shares. However, as the investment amount needs to be paid into a special blocked account with a Swiss bank, related risks appear to be remote. In order to mitigate any potential risks in connection with the advance payment by the investor, the investment agreement usually provides for termination and rescission rights of the investor in case the capital increase cannot be implemented or registered in the commercial register. In the event of termination or rescission, the investment agreement with respect to the investment and the capital increase typically ceases to have a binding effect on the parties, and the parties often agree that in such cases any executed documents are deemed terminated and are without any further effect. Moreover, the company will have to take all necessary actions to unwind any transactions contemplated by the investment agreement, including the repayment of any payments made by the



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investors. It is common that the investor is granted the right to claim damages if, for reasons not within the investor's control, the capital increase cannot be completed.

Investment protection and preferences

Overview

Later-stage (lead) investors who provide substantial investments to the company in a financing round usually seek preferential economic rights over the rights of existing shareholders in order to protect the investment, for example, by way of dividend and liquidation preferences as well as by anti-dilution clauses in the shareholders' agreement. Further, venture capital investors often insist on having certain participation rights in the decision making within the company, such as nominating a board member or consenting to important matters.

Swiss law restrictions on common VC features

Owing to the fundamental principle of Swiss corporate law, that the only obligation of a shareholder towards the company is the obligation to contribute the subscription price for subscribing the shares (article 680 paragraph 1 CO), not all preferential rights of an investor can – to their fullest extent – be mirrored in the corporate documents of the company. For example, the introduction of further obligations of a shareholder in the company's articles of association, such as non-compete undertakings, fiduciary duties or buy and sell obligations of a shareholder, is not possible. For the same reason, the articles of association cannot provide for preferential rights, which would require acts or waivers by other shareholders, for example, sales preferences or financial anti-dilution provisions.

Another important principle under Swiss corporate law is the board's duty to treat all shareholders equally (article 717 paragraph 2 CO). Certain rights granted under the shareholders' agreement, however, could often lead to unequal treatment of shareholders, for example, beneficial subscription rights for the investor or special information rights for the benefit of the investor.

Owing to this corporate law framework, it is common in venture capital practice to rely on contractual obligations in the investment or shareholders'



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agreements in which the contracting parties agree to waive their statutory rights or covenant to vote or act in a particular way for the benefit of the new investor. Non-contracting shareholders, on the other hand, could successfully claim the omission of such equal treatment of shareholders or vote their shares differently, all in compliance with corporate law and without being held liable under the shareholders' agreement. It is therefore crucial that all shareholders are party to the shareholders' agreement and that it can be enforced against all shareholders.

Usual rights of later-stage (lead) investors

Governance and information rights

Later-stage (lead) investors often ask for a right to nominate a representative to the board of directors of the company or to have a board observer. Further, the shareholders' agreement often stipulates strict quorums for certain defined important (board or shareholder) matters, which eventually can only be met if the VC investor (or its board member nominee) agrees. Information rights of shareholders under Swiss corporate law are rather limited. A shareholder below 10 per cent of the voting rights can only exercise its information rights at the shareholders' meeting, for example, by way of information requests directed to the board or, if the information requests remain unanswered, by way of requesting the shareholders' meeting to resolve on the appointment of a special auditor. Therefore, the shareholders' agreement often provides for more extensive information rights to the benefit of the VC investor. Other provisions, which venture capital investors usually want to include in the shareholders' agreement, are provisions regarding lock-up periods, non-competition and non-solicitation undertakings.

Exit provisions and share transfer restrictions

In order to facilitate an exit by way of a sale of 100 per cent of the shares (trade sale) in the company to a proposed buyer, VC investors usually insist on provisions regarding co-sale obligations (drag-along rights). According to such provisions, the investor is granted the right to require all other shareholders to co-sell their shares to the proposed buyer. For minority shareholders, the counter piece consists in the right to co-sell their shares (respectively to oblige



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the selling shareholders to co-sell the shares) under certain circumstances (tag-along rights).

Generally speaking, not only the investors but also other involved parties have an interest in keeping the shares in the company under control (eg, also in view of a potential (joint) exit) and, thus, the shareholders' agreement usually contains an elaborate set of transfer restrictions and regulations on transfer scenarios (including the aforementioned drag-along and tag-along rights, but also rights of first refusal, purchase options, etc).

To mitigate the financial risks connected with their investment in the company, VC investors regularly ask for financial preference rights and for anti-dilution protection in the shareholders' agreement.

(Financial) preference rights

Pursuant to article 656 CO, a company may issue preferred shares with preferential rights in relation to common shares. In particular, preferential rights may relate to cumulative or non-cumulative dividends, to proceeds of the liquidation and to subscription rights in the event that new shares are issued. Such a share category needs to be implemented in the articles of association in order to unfold corporate effects in relation to the company. However, investors will also insist on contractual implementation of the two classes of shares in the shareholders' agreement (ie, common shares for all shareholders except the investor and preferred shares with dividend, liquidation and subscription preferences for the investor).

Therefore, the shareholders' agreement usually also contains a clause regarding the order of precedence, whereas in cases of a conflict or discrepancies between the provisions of the shareholders' agreement and the organisational documents of the company, the provisions of the shareholders' agreement shall prevail between the parties bound by the agreement:

- Dividend preferences: dividend preferences are granted as the first priority to the holders of preferred shares up to a certain amount (preference amount). In VC settings, the preference amount is often defined in relation to the investment amount, for example, a certain percentage. As second priority and subject to the full satisfaction of the holders of preferred



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shares, the remaining amount of the dividend is allocated to the holders of common shares pro rata to their respective shareholdings. The dividend preference rights usually cease to be effective upon completion of an IPO.

- **Liquidation and sales proceeds preferences:** liquidation preferences include the preferential participation of the holders of preferred shares in liquidation proceeds if the company is liquidated (eg, in the case of a voluntary winding-up or forced liquidation scenario). Such liquidation preference rights in the strict sense may be implemented in the articles of association (article 656 paragraph 2 CO). However, in VC transactions, the preference often extends to the sale of shares or to the sale of a substantial part of the company's assets or other transactions (eg, mergers) leading economically to similar results. However, there is legal uncertainty as to whether such a broad definition of liquidation preferences (also extending to transactions at the shareholder level, such as the sale of shares, or divestitures that are not a liquidation) can be implemented in the articles of association owing to the limits imposed by article 680 CO; thus, respective rights and obligations have to be agreed contractually in the shareholders' agreement.
- **Subscription preferences:** pursuant to Swiss corporate law, each shareholder has a subscription right to newly issued shares pro rata to its shareholding prior to a capital increase, unless the subscription right has been cancelled or limited by the shareholders' meeting. With the subscription preference right, the holders of preferred shares may be granted the right to subscribe for larger proportions of newly issued shares or have preferential rights to subscribe for all newly issued shares. While dividend preferences and liquidation preferences are commonly agreed upon in the shareholders' agreement and, to a large extent, can be mirrored in the articles of association, subscription preferences are less frequently seen.

Anti-dilution (down-round) protection

Common anti-dilution clauses in the VC context aim to protect the investment by way of a compensation from down rounds (financial dilution). A down round is a future financing round in which the subscription price of the shares is lower than the issue price of the financing round in which the investor has



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previously invested in the company. Therefore, the investors will be protected if, in retrospect, they had overpaid for their shares in the initial investment.

Accordingly, the anti-dilution protection aims to reduce the price for all shares held by the protected investor to either an average of both financing rounds or to the level of the down-round (anti-dilution adjustment). The anti-dilution adjustment is either settled by transferring a certain number of shares from the existing shareholders to the protected investor for free or, likewise as for the compensatory capital increase in case of breach of representations and warranties given by the company, by way of an additional capital increase in which the protected investor is granted the right to subscribe for such shares at their nominal value.

A full ratchet anti-dilution protection is the most investor-friendly type of protection and aims to put the investor in a position as if the shares received in the previous round had been subscribed for the same price as in the down round. For the existing shareholders, the full ratchet anti-dilution protection is the most dilutive and may lead to considerable change in the ownership of the company. As an alternative to prevent a marginalisation of the founders, often a weighted average calculation method is used to calculate the anti-dilution adjustment. With the weighted average calculation method, the investor is put in the same position as if the shares received in the previous round had been subscribed for the weighted average price of both financing rounds.

Overall, VC investments in emerging growth companies can be very attractive to financial and strategic investors and may offer opportunities. However, they need to be carefully structured and reviewed from a legal and tax perspective in order to properly reflect deal terms and to provide for adequate protections on a contractual and corporate level to satisfy the needs of institutional investors.



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