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Protection of the investor in financing rounds: selected questions

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Introduction

The purpose of this article is to highlight certain questions and issues drawn from practice in connection with contractual protection of private equity investors in Swiss companies during financing rounds.

The following topics will be discussed below: (I) control rights granted to the investor, (II) traps to watch out for when investing trough convertible loans, (III) certain pitfalls to watch out for when considering a future IPO of the company and, finally (IV) certain practical suggestions to manage a large group of shareholders.

I. Control rights

The extent of control that will be granted to the investor will depend on the size of his or her investment relative to the founders, on the one hand, and to the other investors, on the other.

Without going into lengthy discussions of divergent and convergent interests between the founders of a company and the investors financing its development, we should point out that a business's success often largely depends on its management. If you decide to invest in the capital of a carefully selected company, you need to ask yourself whether it is always in your best interest to increase the powers of the other investors who belong to your group but are not necessarily under your control. In other words, would the investor rather trust the management team or the group of investors? The answer will often depend on the type of problems and the circumstances.

In my opinion, an investor's actual control over a company is based on three pillars: information, influence on company decision-making, and the right to veto certain decisions.

1. Information

a) *The legal system*

It is a well-known fact that the shareholder's statutory rights to information are very limited under Swiss law. This is a logical consequence of the fact that the shareholders have no duty of loyalty or fiduciary duty to the company: since the company is not protected against misuse of information by shareholders, significant restrictions must be imposed on the information disclosed to them. That is why the relevant Swiss law (Code of Obligations

["CO"]), in its current state, only grants shareholders the right to obtain the annual report (CO 696) and to ask questions at the general shareholders' meeting, while the possibility of inspecting company documents is subject to prior approval by the general shareholders' meeting or by the board of directors (CO 697). The new Swiss Code of Obligations ("nCO") governing the *société anonyme* ("company limited by shares" (U.K.) or "stock corporation" (U.S.)) will moderately extend the shareholders' right to information, mainly by permitting shareholders owning a certain minimum percentage of shares to submit questions to the board of directors (nCO 697) and to ask to inspect company documents at any time rather than only during the general shareholders' meeting (nCO 697a). Yet the new Code of Obligations, like the present one, will continue to take the company's interests into account (particularly by protecting business secrets) by relying on a specific procedure (called the "special audit" under CO 697a et seqq. or the "special examination" under nCO 697c et seqq.) involving an independent third party under the court's authority whenever a shareholder's legitimate interest in obtaining information is in conflict with the company's legitimate interest in confidentiality.

b) Issues related to contractual rights

The parties must therefore resort to contractual documents (usually the shareholders' agreement) in order to provide more extensive rights to information in exchange for the shareholders assuming obligations of loyalty, confidentiality and even non-competition. The boundaries of such reciprocal rights and obligations will be negotiated on a case-by-case basis, particularly as a function of the parameters discussed below.

- *Risk of misuse.* The assessment of the risk of a potential misuse of the disclosed information will depend, firstly, on the nature of the company's activities, which may be more or less vulnerable to disclosure of information and, secondly, on the type of investors involved. As a rule, institutional investors (including venture capital or private equity funds) are less likely to misuse the information transferred to them than competitors or other actors in the same line of business. Yet there are exceptions to that general rule, especially if a fund's investment portfolio includes other companies operating in the same field. Such situations often give rise to complex negotiations: the fund may be neither willing nor able to assume binding obligations, especially not by restricting its own freedom or that of the portfolio companies, while the company and the other investors may wish to prevent a harmful transfer of confidential information through a system of "Chinese walls".

- *Management attention.* When determining the extent of the rights to information guaranteed by the agreement, the parties must give due consideration to the amount of time and attention required to that purpose. Detailed monthly reports, accompanied by oral presentations, while they may appear desirable to the investors, will probably have the effect of distracting management from its main task: developing business to the benefit of all concerned.
- *Investors' internal obligations.* Some investors are subject to internal rules governing disclosure to their own shareholders, which require them to obtain certain information from all their portfolio companies. Such obligations should be identified early enough in the negotiation process of a financing round because in extreme cases those obligations may become a serious impediment to the transaction.
- *Risk of liability as a de facto corporate body.* Investors who receive extensive information combined with exercise of other control rights (particularly veto rights discussed below) may incur the risk of liability as a *de facto* corporate body in the event that the company goes bankrupt.[1] In their own best interest, investors therefore need to find the right balance in the level of information and control contractually granted to them.
- *Equal treatment.* Insofar as all the shareholders are parties to the shareholders' agreement governing the rights to information, it seems to me that the board of directors is entitled to abide by the corresponding provisions without being blamed for violating the principle of equal treatment. In contrast, shareholders who are not parties to the shareholders' agreement might complain of a violation of that principle. The principle of equal treatment is relative, however, and permits (or even requires) differential treatment of shareholders in different situations. In my opinion, it may therefore be justifiable to withhold certain information from shareholders

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[1] Fed. Sup. Ct. 4A_133/2021 of 26 October 2021: "Liability under [CO 754] applies [...] not only to members of the board of directors but also to *de facto* corporate bodies ('*organes de fait*'), i.e. to anyone involved in the management or liquidation of the company, that is to say, all persons who actually make decisions normally reserved for the directors and officers or who provide for the company's management, thereby making a decisive contribution to shaping the company's will (ATF [Official Collection of Fed. Sup. Ct. Decisions] 132 III 523 c. 4.5 p. 528 et seq.; 128 III 29 c. 3a p. 30 et seq.; Judgment 4A_294/2020 of 28 December 2020 c. 3.1). To be recognized as a *de facto* corporate body, a person must have had an enduring power to make decisions going beyond the performance of routine daily tasks and have decision-making power that appears to be personal and independent and was therefore in position to prevent the occurrence of the damage (ATF 136 III 14 c. 2.4 p. 20 et seqq.; 132 III 523 c. 4.5 p. 528 et seq.)."

who are not parties to the shareholders' agreement, on the grounds that they did not assume any obligations of confidentiality or loyalty vis-à-vis the company. But that question may be difficult to evaluate and the board of directors must be careful whenever the shareholders' agreement does not cover all of the share capital.

c) *Various types of information clauses*

Without claiming to be exhaustive, it seems to me that is possible to classify contract clauses granting a right to information according to several different approaches:

- *Information provided unasked or on demand.* Information clauses generally require borrowers to provide information unasked regarding certain specific points: the annual financial statements and audit report, budgets, management accounts, verification of achievement of the business plan milestones, announcements of particular events (patent filings, litigation, sanctions, major contracts). In addition, investors are often entitled to receive the documents submitted to the members of the board of directors. Yet such agreements frequently also allow investors to obtain information on demand, especially in order to comply with regulatory constraints or to meet their obligations to their own investors.
- *Written or oral information.* The information usually consists of written communications or reports. It is advisable for investors to reserve the right to conduct interviews (periodically or on request) with the company's managers in order to gain a better understanding of the company's concrete situation.
- *Passive or dynamic information.* In addition to receiving the documents and information provided to them by management, it may be advisable for investors to become personally involved in regular monitoring of the borrower's business by placing a member or observer on its board of directors (see below).

d) *Right of verification*

To ensure the correctness of the provided information investors should reserve a contractual verification right. Such verification may take the form of interviews with the board of directors, the management, the auditors or inspection of the company's books. To cover the issues related to protection of business secrets, it is not uncommon to resort to the intervention of an independent third party to verify certain sensitive information.

This verification right raises certain questions in practice, since it is necessary to strike the right balance between the risk of defrauding the investor by disclosure of inaccurate or incomplete information, on the one hand, and the risk of business disruption by investors who are fussy and suspicious or who simply want to sow discord for tactical reasons.

- *Right to take away copies*? In my opinion, in the absence of clause to the contrary, the right to inspect documents does not imply any right to be provided with copies. On the other hand, absent special circumstances, the holder of the inspection right is entitled to make his own copies of the documents inspected, providing that he/she guarantees confidentiality and security.
- *Prior notice*? The shareholders' agreement often calls for a minimum notice period. If that is self-evident in the case of handover of documents, the same should be true, in my opinion, for visits to the company's premises or interviews with directors and officers. Although the investor's concern to keep management from tampering with the information during that period is understandable, the parties should bear in mind that the company is exposed to operational risks related to the unexpected arrival of a team of experts (upsetting of the personnel, disruption, tactical manoeuvres in a war among shareholders, etc.).
- *Right to choose interlocutors*? Although rare in practice, a contract clause could conceivably guarantee investors the right to choose the person within the company to answer their questions. For example, investors who practice due diligence know that it is sometimes most interesting to obtain an unprompted answer from an accountant about such and such unusual practice within a company rather than an answer that was prepared in advance by the CFO! Naturally, just as with the issues of prior notice mentioned above, the possibility of direct contact with low-ranking employees, who are often unaware of the nature of the relations between the management and investors, exposes the company to certain operational risks.

2. Influence: participating in the board of directors

a) *Appointing a director*

Investors are generally entitled to appoint one or more representatives to the board of directors. That right enables investors to obtain information dynamically and to participate in shaping the will of the company and defending their own specific interests.

Note the following points:

- *"Representative"*. The expression investor's "representative" is a malapropism since the primary obligation of the appointed director is to safeguard the company's interests and he is not permitted to blindly follow the instructions of the shareholder whom he "represents".[2] In practice, however, one has to admit that investors' representatives keep in the forefront of their mind the protection of the interests of the person who appointed them.
- *Majority*. The balance of forces on the board of directors is often a hotly disputed topic in the negotiations of a financing round. When the investors are unwilling to give up their demand for a majority, but the founders claim a dominant position on the grounds of their knowledge of the field, the deadlock may be broken by entitling one side or the other to appoint the majority of the board members under certain conditions (such as achieving or failing to achieve certain milestones).
- *Eligibility of the appointee*. Cohesion among the board members is one of a company's keys to success, especially in the event of a crisis or tense situation requiring fast, united action. The human factor therefore plays an important role, hence the opportunity to provide for criteria of eligibility for directors in the shareholders' agreement. While the parties generally acknowledge that the founders, as individuals, are eligible to hold a seat on the board of directors, independent directors and investors' representatives should be reasonably acceptable, and the shareholders' agreement should stipulate who has the right to object to them as well as the terms and conditions of making such objections (presenting a new candidate, limited number of objections, mediation, etc.).
- *Minimum shareholdings*. The shareholders' agreement often makes the right to appoint a director conditional on holding a certain minimum percentage of the share capital, thereby eliminating or suspending this right if the relevant investor is diluted below the agreed percentage. This clause is rarely applied as such, since the right to appoint directors, like the privileges attaching to the shares, is generally renegotiated at each financing round to strike a new balance among the founders, the independent directors, the existing investors and the newcomers.
- *Dismissal*. In order to be full and effective, the right to appoint a director must be accompanied by a clause allowing investors to dismiss their representative and appoint a new replacement. On the other hand, it would

[2] On issues with representatives within the meaning CO 707 (2), and the resulting "dual nexus of duties", see, in particular, CR CO II-Peter/Cavadini, no 20 et seqq., especially no 22, art. 707.

be contrary to the mandatory provisions governing companies limited by shares (CO 705) if the shareholders' agreement had the effect of preventing the general shareholders meeting from dismissing a member of the board of directors for good cause.[3]

- *Protection of the board members.* The shareholders' agreement often requires the company to take out civil liability insurance for its directors and officers ("D&O insurance") to provide them with coverage if they cause damage to the company or third parties. It is advisable for the person appointed by an investor as a company's board member to ask, in addition to the D&O insurance, that the investor itself provide indemnification if such person is held liable for following its instructions.

b) *Appointing an observer*

The parties generally wish to ensure that the respective influences of the founders, the investors and the independent directors (experts in the field) remain balanced. Certain significant investors may insist on attending board meetings, however, to make sure they are kept as fully informed as possible. That is when the role of board observer comes into play. The appointment of a board observer calls for the following remarks:

- An observer will bear less liability than a director, especially if the observer actually refrains from exceeding the assigned passive role. According to the "*de facto corporate body*" theory, however, observers are not exempt from liability if they assume an active role on the board of directors so that their opinion is taken into account and proves to be decisive on certain matters.
- Not being a corporate body of the company, the observer is not legally subject to the duties of care, loyalty and equal treatment applicable to the directors (CO 717). It is therefore essential to require observers to sign specific confidentiality and non-compete undertakings when they first take office.[4]

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3 According to an unpublished precedent from the Canton of Vaud, summarized and criticized by Wilhelm/Bloch, 108, any shareholders agreement clause that expressly appoints directors by name for an unlimited period is null and void (according to the *prima facie* standard applicable in interim measures) on the grounds that such a clause infringes the general meeting's inalienable right to remove directors. Also see Marchand, 1083, no. 3.4; CR CO II-Peter/Cavadini, no. 2a, 704: "[T]he general shareholders meeting's right of dismissal cannot be eliminated or even restricted, whether by contract or by the articles of association".

4 DuPasquier, 278.

- Finally, even if the board observer does not formally vote, the psychological impact of one or two additional investor representatives should not be underestimated: the speaking time, physical presence and body language are intangible but quite real factors that influence the balance of power within the board of directors, particularly when negotiating sensitive issues.

3. Veto rights

For certain important decisions, investors generally demand a right of veto, especially when they form a minority on the board of directors. I have already mentioned the dilemma of trusting the founders rather than co-investors, but the adage "he who pays the piper, calls the tune" must prevail in specific cases.

The veto right is legally problematic, especially when it comes to decisions by the board of directors. While Swiss rules on limited liability companies expressly provide for the possibility of granting a veto right under the articles of association (CO 807), legal scholars consider that the articles of association of a company limited by shares may not provide such a right for resolutions falling within the powers of the general shareholders' meeting[5], or decisions of the board of directors[6]. Certain authors consider that such a right of veto against decisions of the board of directors, even if contractually guaranteed under a shareholders' agreement, would be contrary to the fundamental principles of corporate law[7].

One practical workaround for this problem consists in providing for a qualified majority (which requires the participation of the directors representing the investors) for important reserved decisions. Yet even this practice must be considered cautiously: citing a Zurich Commercial Court Judgment of 2015[8], the authors of the SECA model shareholders' agreement[9] propose two

[5] Although unanimity is required by law for certain important decisions (conversion to not-profit status (CO 706(2)(4)); the holding of an "*assemblée générale universelle*" [a general meeting attended by all shareholders] (CO 701(1)); waiver of the audit of the financial statements (CO 727a(2)), the majority requirements should not result in blocking the company's conduct of business. Cf. CR CO II-Peter/Cavadini, nos. 12 and 14, 703.

[6] Böckli, §13, no. 121a et seq.; CO II-Peter/Cavadini, no. 4, 713 and the reference cited in note 12.

[7] See on this topic DuPasquier, 292 and the references cited.

[8] Zurich Commercial Court (HG ZH) Judgment No. 140114-O of 28 October 2015 c. 4.3.4.

[9] Cf. notes 21 to 23 of the model shareholders agreement (SECA Shareholders Agreement, 4th edition, November 2019).

alternative clauses in this area, depending on the parties' appetite for legal risks! Without claiming to settle this debate here, I merely wish to point out that the Zurich judgment in question lays down two clear principles:

- A requirement for a qualified majority on the board of directors cannot be based on articles of association or organizational regulations that are binding on the company itself, since that would violate the principle of equal treatment among board members;[10]
- On the other hand, such a qualified majority and even a veto right are expressly permitted in a shareholders' agreement that is not binding on the company.[11]

I therefore consider that a shareholders' agreement may validly grant a right of veto or provide for a qualified majority that necessarily includes investor representatives.

II. Convertible loans

1. Background

It seems to be increasingly popular to finance start-ups through loans convertible into shares, especially in the following circumstances:

- *Bridge financing*. When it takes longer than expected to finance the company and the company's needs call for an immediate cash contribution, an existing shareholder often grants a bridge loan of an amount sufficient to meet the cash requirements until the probable closing date of the negotiations, which is generally in the near future. The loan conversion is performed under the terms and conditions of the next financing round, with the conversion price often being nearly 100% of the issue price of the next round, at least when the closing seems certain.
- *Gain time*. If the parties with to proceed with an investment while disagreeing on the valuation of the company, or if there are still too many contingencies to determine a definite value, it is not uncommon for the parties to proceed with a convertible loan. In that case, the terms of

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10 HG ZH No. 140114-O c. 4.3.4: "*That is precisely what these provisions of the Organizational Regulations are opposed to. The negative votes/abstentions of the 'B Directors' are differentiated from those of the other board members, which is incompatible with the principle of equal treatment.*"

11 HG ZH No. 140114-O c. 4.3.4: "*[T]here is no problem agreeing to veto rights under a non-binding shareholders agreement in any case.*" Also see Groner, 315 et seqq.; Marchand, 1087, no. 3.5; Premand, 139, no. 527; Wyss, 514.

conversion will be set by reference to the next financing round, i.e. the right to subscribe, by way of set-off, for the same class of shares as those issued in the next round, but at a price of conversion (or subscription) often reflecting a discount on the order of 15 to 30%, depending on the risk assessment.

- *Need for protection in case of insolvency.* Some investors would rather keep their investment in the form of a loan, so that they will receive the preferential treatment reserved for creditors as compared to shareholders in the event that the company goes bankrupt or is sold at a very low price to a third party (which will *de facto* be forced to ensure that the company honours its debts). If, in contrast, the company's business is booming, the conversion feature will allow the investors to profit from the potential gains reserved for shareholders. In this way, the lender gets "the best of both worlds". It should be noted that, unlike an investment in capital, a convertible loan is accounted for as debt on the company's balance sheet, so that it is considered in the calculation of overindebtedness for the purposes of CO 725(2). Convertible loans must often be subordinated in order to avoid notifying the bankruptcy judge, which renders the above-mentioned classification as debt less attractive.
- *Restructuring.* Finally, loans are sometimes converted to equity not because that was originally planned by the parties but as a restructuring measure for a company that subsequently experiences financial difficulties. In that case, conversion is neither a right nor an obligation but only a common desire to find a solution ensuring the company's survival.

2. Constraints under the Code of Obligations

a) *Conditional capital*

Under CO 653b (3), the conditional capital enabling conversion of the reimbursement claim under the loan must exist before the conversion right is granted. In the absence of such conditional capital, the conversion right is "void" according to the wording of the law. Similarly, CO 653 stipulates that conditional capital may be used for conversion "of bonds or similar debt instruments".[12]

In practice, however, convertible loans are often granted in forms other than bonds or similar debt instruments (particularly by a single lender) and without underlying conditional capital. Such practices are not very problematic if all

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[12] These two rules remain unchanged in the new Code of Obligations.

the shareholders sign the convertible loan agreement or otherwise undertake to perform all acts necessary to enable conversion under the specified conditions. Yet the issue becomes more acute whenever the company is unable to obtain the consent of all its shareholders - which happens in practice in companies with a dispersed shareholder base and pressing needs for a financing solution.

Although there is to my knowledge no case law on this subject, I consider, in agreement with the prevailing scholarly opinion quoted below, that the practice in question is legally valid, subject to the following qualifications:

- The expression "similar debt instruments" should be interpreted broadly so as to permit using the conditional capital to guarantee a conversion right related to any form of debt, whether certificated or not, even if there is only a single lender.[13] The structure of the loan should nevertheless ensure that the existing shareholders have the option of participating, to the extent that they have not waived it (see item b) below).
- "Nullity" (in the classical sense) of conversion right is not a suitable sanction. By prohibiting the issuance of options or conversion rights without conditional capital, the CO basically intends to prohibit the granting of such rights without coverage, in order to protect shareholders against a dilution they have not previously accepted. There is no reason to void such options or conversion rights insofar as the company is actually capable of covering them, particularly if it holds sufficient treasury shares at the time of the grant or if the general shareholders meeting votes in favor of the corresponding conditional capital or if treasury shares are acquired. The conversion right is not "void" but merely suspended (*suspendu, schwebend unwirksam*), to the extent that company is incapable of delivering the shares in case the conversion right is exercised.[14] In any case, the ineffectiveness provided by law only affects the company's obligations, not the shareholders' obligations, whenever the shareholders have undertaken to allow the conversion, e.g. by signing the convertible loan agreement or pursuant to the shareholders' agreement.

Finally, adopting the appropriate conditional capital raises another difficulty: in practice, it often happens that the category of shares to be issued upon conversion has not yet been determined when the loan agreement is signed. That share category will be defined in reference to the next financing round, the terms of which are still unknown. The conditional capital clause is

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13 CR CO II-Zen Ruffinen/Urben, no. 12, 653; BSK OR II- Zindel/Isler, no. 13 et seq., 653; Böckli, § 2, n. 209.

14 Reutter, 207; Böckli, §2, no. 204; CR CO II-Zen Ruffinen/Urben, no. 18, 653b.

therefore complicated to draft and its validity may be called into question, insofar even as it is capable of being recorded in the commercial register.[15] I therefore recommend obtaining the shareholders' express consent to the convertible loan, whenever possible, together with an undertaking to take the necessary steps to implement its terms. If the company has a dispersed shareholder base, it is useful for the shareholders' agreement to grant the right for a qualified majority of shareholders to consent to a convertible loan – or more generally to a financing round – and the obligation of the other shareholders, in such a case, is to proceed to perform all such actions as are necessary to enable the conversion.

b) Right to subscribe prior to the loan and preferential subscription rights

CO 653c, based on the assumption that conditional capital is available, requires that the existing shareholders be offered the possibility of participating in the convertible loan, since their holdings will be diluted at the time of conversion and they will not be able to exercise their preferential subscription rights at that time (CO 653c).

As indicated above, to the extent that it is possible to have all the shareholders express consent to the terms of the convertible loan, such consent will include a waiver of the right to participate in the convertible loan (or, if there is no underlying conditional capital, a waiver of the right to subscribe for the shares to be issued upon conversion).

Whenever such express consent cannot be obtained, it is necessary to pay very close attention to the process, which must take the following parameters into account:

- The investor must be able to count on a fixed investment amount, which implies being able to identify at an early stage which shareholders wish to participate (on a pro rata basis) in the convertible loan.
- The existing shareholders need to be familiar with the terms and conditions of the loan to make an informed decision whether to exercise or waive their right to participate in the loan.

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[15] In 2014. the following clause of the articles of association was allowed in the commercial register of the Canton of Vaud: "The share capital shall be [...] increased by issuing a maximum number of [...] registered preferred shares, of the Category [...] *or of the same category as the one entered at the time of the first capital increase, which category may be decided after entering the present article* in the articles of association, namely on [date]..." (my underlining).

- The parties (particularly the investor) will not be willing to make the effort and incur the costs of preparing the paperwork until the final terms and conditions have been fixed, including the amount to invest.
- The schedule is usually tight and does not allow for a lot of back and forth.

In such a context, the following may be a workable solution:

- Negotiating the main terms of the convertible loan agreement with the investor in the form of a term sheet;
- Contacting the main shareholders to find out whether they are interested in participating and, if so, including them in the negotiations with the investor; this phase makes it possible to arrive at an estimated amount of the investment, bearing in mind that minor shareholders tend to participate only marginally in following rounds;
- Preparing a term sheet addressed to all the shareholders along with a letter describing the transaction and setting a deadline for them to express their interest in participating in the convertible loan, failing which, they will be deemed to have waived their right to participate in the convertible loan and their preferential subscription right at the time of conversion. Circumstances permitting, the company may attach to the term sheet a notice of the general shareholders meeting to vote on the necessary conditional capital and a proxy form for the exercise of voting rights at that general meeting.
- Based on the shareholders' responses, upon expiration of the fixed decision-making period, preparing and signing the final documents, holding the general meeting and disbursing the loan.

The above process calls for the following legal comments:

- *Term sheet.* I consider that the term sheet provides a sufficient basis for a valid waiver by the shareholders of their right to participate in the loan: provision of the final documents is not a requirement for such a waiver. The situation is delicate, however, in the case of an investor trying to insert last-minute amendments in its own favour, e.g. by alleging that the company's situation has deteriorated. In such cases, it would be prudent to submit the new terms to the shareholders, with a short time limit to respond if interested; it would also be prudent to indicate in the initial communication to shareholders that a fast response may be required from them in case the final documents deviate from the term sheet.
- *Tacit waiver.* I consider that failure by a shareholder to respond by the imparted deadline amounts to a valid waiver of the right to participate in

the convertible loan and in the subsequent capital increase. Here again, a clause of the shareholders' agreement specifically providing for such a mechanism would be welcome for the sake of legal certainty.

- *Subsequent modifications.* Finally, it is an open question how the convertible loan agreement may be subsequently modified by agreement between the lender and the borrower company. In light of the shareholders' waiver of their preferential subscription rights, granted in reference to a given transaction, is it permissible for the lender to obtain certain benefits in exchange for a waiver of the exercise of certain rights (e.g, the right to demand reimbursement if a milestone is missed or if representations and warranties are breached)? On the other hand, can the company grant a grace period to an investor who is unable or unwilling to pay the amount of his investment by the agreed deadline?
- *Rights of existing convertible loan holders.* The piling up of successive convertible loans often creates a remarkable level of complexity. In addition to conversion issues (see 3 below), it is necessary to determine the extent to which lenders who presumably have not yet converted their loans are entitled to participate in a new convertible loan when no financing round has occurred. CO 653d (2) contains very general rules about protecting holders of conversion and option rights against dilution. Does this right include the possibility of participating *pro rata* in a future convertible loan? If so, how should the *pro rata* be calculated, since the subscription price (hence, the number of shares to issue upon conversion) is still unknown? In practice, it is worth the effort to anticipate that eventuality by including a suitable clause in the convertible loan agreement that establishes the basis on which the lenders of the first convertible loan may participate in the second, or by excluding that right to participate.

Note that the foregoing issues related to the term sheet and tacit waiver are likewise found in an ordinary financing round, without a convertible loan: the only difference is that the immediate capital increase makes it possible to quickly eliminate any debates about the preferential subscription right, whereas that question may remain unresolved until the time of conversion in the case of convertible loans.

3. Conversion and conversion rates

The conversion of a loan into shares is nothing other than a subscription for shares by means of a set-off against the debt claim under the loan.

a) *Mechanism of set-off*

By exercising its right of set-off, the lender declares its intent to subscribe for a number of shares calculated by dividing the amount of its loan (plus any interest) by the price per share under the convertible loan agreement. If the convertible loan is based on conditional capital, the lender immediately becomes a shareholder upon declaring its intent to exercise the conversion right; otherwise, a transfer of treasury shares by the company or a capital increase (ordinary or authorised) must be made.

The agreed interest on the convertible loan receivable raises withholding tax issues that I do not address here but that should not be overlooked whenever the number of (non-bank) lenders exceeds 10 (for a single loan) or 20 (for all loans together).[16] An alternative solution that may be considered by the parties is to set a progressively increasing discount off the conversion price.

b) *Mandatory or optional conversion*

The convertible loan agreement should clearly distinguish cases in which the lender has an obligation to convert (the company may demand conversion) from cases in which the lender merely has a right to convert. There is no universal rule. The agreement must provide a solution suited to the particular situation. As a general rule, a conversion is mandatory during the next financing round, as is also the case upon achieving certain definite milestones. Conversion is sometimes possible before maturity, generally at the lender's option, even in the absence of a financing round. It is advisable for the lender to provide for a conversion right at all times in case of the sale of the company, failing which, the lender might lose the profit from a sale of the company!

It is useful for the convertible loan agreement to provide a mechanism to force conversion, as much as possible, if the lender fails to cooperate. Given that the lender must subscribe for the shares, the loan agreement may contain a power of attorney to perform all actions giving effect to the conversion, including by signing a declaration of intent to exercise the conversion right, a subscription form etc. This solution is not completely satisfactory since the power of attorney, even if granted jointly, may be revoked at any time,[17] but in any case it helps to palliate the lender's inaction, if not its active opposition.

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16 On this subject, see, for example, Oesterhelt, 755.

17 CR CO I-Chappuis, no. 7, 34. ATF 118 II 496 consid. 5b p. 499 et seqq.: "[T]he power of attorney must be unanimously granted to the representative of the estate and may be revoked by one single person at any time".

c) *Anti-dilution*

The conversion – and discount involved – may have surprising effects by triggering the unexpected application of an anti-dilution clause agreed in an earlier financing round[18]. Indeed, if the discount is 20% and the share price in the round in which the anti-dilution clause was adopted is CHF 20, and the next round of financing provides for a share price of CHF 23 (i.e. higher than the price in the previous round), the lender will be able to convert at a price of CHF 18.40 (80% of CHF 23), i.e. a price lower than the price in the reference round for anti-dilution. It is therefore recommended to decide for each financing round whether or not the anti-dilution clause will also apply to the subscription price applicable to the convertible loan holders. Moreover, it is advisable to specify whether the anti-dilution clause will apply to all subsequent rounds or only to the immediately following round, and whether it may apply more than once.

d) *Piling up of convertible loans*

Without going into the details, it is important to bear in mind that, while a convertible loan may be a convenient means of postponing the valuation of the enterprise to a later date, it may be problematic to repeat the practice before having converted the first loan. In fact, the calculations of conversion, the rights to which the various convertible loan holders are entitled and their interrelationships are very complex, since they are made by reference to a price that is still unknown and the diluting effects of one loan on the other are difficult to ascertain. We shall see in the next section that this situation is also problematic in the event of an IPO of the company, which requires a clear presentation in the prospectus of the company's capital structure that is difficult to provide.

III. Issues related to an Initial Public Offering (IPO)

The objective of this section is not to give a detailed description of all the steps in a company's IPO (*Initial Public Offering*) but rather to highlight a few issues that tend to arise in practice. Many of the points mentioned below are related

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[18] An anti-dilution clause is intended to protect an investor against the diluting effects of a subsequent financing round on a share price lower than in the current round. In such cases, the anti-dilution clause entitles the investor to obtain shares (either by subscribing for new shares at nominal value or by acquiring existing shares from other shareholders) so as to reduce the investor's average purchase price. There are several variants of this calculation, which may be more or less favourable to the investor.

to the fact that the IPO process requires substantial, lengthy preparation before finding out the essential part of the transaction: the pricing of the issue and the "go/no go" decision, which come at the very end of the process, whereas the publication of the prospectus, the due diligence and all the marketing activities have been implemented beforehand.

1. Single share class

Today, it seems inconceivable to carry out an IPO of a company whose capital would retain preference shares. The market shows a clear preference for a single share class[19], so that all privileged shares must be converted into ordinary shares before any IPO process. Most shareholders' agreements provide for such an automatic conversion in the event of an IPO, but it often results in a loss of privileges for the investors, with no compensation.

It is possible to provide a compensatory mechanism (e.g., by issuing new shares at par value). The difficulty in that case is that the agreement must contain an abstract definition of a formula to calculate the reference value needed to calculate the privileges and thus the number of additional shares to be issued to compensate for the loss of such privileges, and that number will not become known until the last moment when the IPO issue price is set. Unless the shareholders' agreement provides such a mechanism in advance, it will be difficult to get the other shareholders to waive their preferential subscription right.

Finally, if the IPO ends up not being implemented, it will be necessary to reinstate the *status quo ante* (mainly the privileges) which will be complicated if some compensatory shares have been distributed and must be cancelled.

2. Conflicts of Interest

A company about to go public has often already completed several rounds of financing, and the investors who participate in its capital sometimes differ in terms of their situations and interests:

- Certain investors who have been involved ever since the earliest years of the company' life can no longer continue to invest (since their fund's investment period has expired), will earn a potentially substantial profit even with a moderate valuation and need to exit (sale or IPO) on short

[19] Subject to the existence of shares with preferential voting rights in certain listed companies that have a reference group of family shareholders concerned about maintaining control without holding the majority of the capital's nominal value.

notice so they can refund to their shareholders the funds they have advanced. These investors often have privileges inferior to those of the new investors, so that a conversion of all the shares into ordinary shares does not bother them so much and may even benefit them.
- Other investors who bought into the capital at a later stage paid a higher price and expect a more substantial increase in value; they have the means of funding new financing rounds, potentially on terms that are favourable to them if they manage to secure a position of privileged interlocutor.

An IPO, while it may be attractive to founders who view capital market financing as a means of maintaining control over their company, is often not the preferred exit scenario for investors:
- The market cannot provide the premium that a strategic investor is ready to pay for the synergies.
- In an IPO, the company will not attempt to maximize the share price so as to leave room for potential appreciation of the share price in the future and thus maintain the trust of the stock market in the medium and long term.
- It is generally prohibited for existing shareholders to sell their holdings within a 6 to 12-month period after the IPO (*lock-up period*); after that, the sale remains complicated if the investor wishes to avoid making the share price drop substantially by offering to sell a substantial block of shares.
- The fact that a company has gone public reduces the likelihood of being sold later to a strategic investor due to the complexity of public tender offer processes.

In light of the foregoing, it is not uncommon to see investor representatives on the board of directors (who are often majority shareholders at this point) fighting to promote the solution most favourable to their specific situation, without much consideration for the interests of the company. This may result in inextricable deadlocks that cannot be resolved without the risk of a major crisis accompanied by collateral damage to the company.

3. Special Clauses of Shareholders' Agreements

Certain clauses of shareholders' agreements deserve special attention in connection with an IPO. It is not uncommon, at the start of the IPO process, for the parties to realize that they need to modify or supplement the shareholders' agreement, which is too often drafted with a sale as the main exit scenario.

Qualified IPO. The shareholders' agreement sometimes provides for different majorities required to trigger an IPO process, depending on whether the IPO

is "qualified" or not, that is to say, whether it allows investors to earn a certain multiple of their investment. Since the IPO issue price is set at the end of the process, such clauses only mean that such qualified majority may oppose – at the last minute – the launch of the IPO. It must therefore be kept in mind that this right of opposition does not create any right to launch an IPO but rather the right to stop it at the last minute.

Capitalization Table. The rules for drafting a prospectus in an IPO require the company to give a clear presentation of its shareholding structure immediately after the IPO.

- With that in mind, options or conversion rights that enable the acquisition of shares at a fixed price (other than employee options, which are generally accepted in the market) should be prevented from surviving the IPO, as far as possible. In fact, the market often reacts negatively to rights to subscribe for shares on preferential terms.
- More generally, it is advisable to simplify the capital structure, if possible before going to the notary who participates in the execution of the capital increase on the day preceding the IPO. In particular, having to convert loans, exercise options, or issue shares with an anti-dilution effect on the day preceding the IPO should be avoided. First of all, in the marketing phase (roadshow), such activities would complicate communications with investors, who would have to devote too much energy to understand the factors determining their share of capital for a given investment, to the detriment of their understanding of the business model. Secondly, since the number of shares is calculated on the basis of the final price, such calculations cannot be performed until the last moment; pre-validation of the documents by the commercial register will have only a limited effect and the multiple documents required for the issuance of new shares, originating from different signatories, will have to be finalized in a hurry. All such factors increase the execution risk, which is already significant given the complexity of the IPO process itself.

Other clauses. It is important for the shareholders' agreement to provide for a shareholder undertaking to accept being temporarily prohibited from selling their shares after the IPO (lock-up period), while at the same time leaving the company and the banks some leeway in defining that that period, if possible. The agreement may also provide for a shareholder undertaking to lend the banks a portion of their shares for a relatively short time in order to allow for the market placement of such additional shares, where appropriate ("greenshoe", or over-allotment, option). Finally, the agreement should stipu-

late that it will terminate automatically in the event of an IPO (i.e. on the first trading day) so that it can be unequivocally stated in the prospectus that there is no longer any shareholders' agreement.[20]

IV. Managing large groups of shareholders

The needs of a start-up often call for fast actions, which are incompatible with the relatively strict rules of company law. One of the problems often encountered is the lack of response on the part of minor shareholders who have now lost interest in the company, whether former employees, early fans disappointed by the dilution imposed by the following financing rounds, or retired business owners currently sailing around world!

Here are a few practical suggestions to handle such situations:

- Provide a clause allowing a significant majority (80 to 90%) to modify the shareholders' agreement without the consent of the remaining shareholders. The validity of such a clause has not been put to the test, as far as I know. In my opinion, the clause should be considered valid at least insofar as the shareholders who did not consent are not affected by it to a greater extent than the other shareholders, taken as a whole. Such a clause also turns out to be useful, or even indispensable, to enable adapting the shareholders' agreement on the occasion of a new financing round when it is not possible to collect all the shareholders' signatures.
- To the same purpose, the shareholders' agreement may contain a presumption, accepted by each signatory, that the shareholders will accept the proposals that will be addressed to them by the company's board of directors (or a representative appointed to that effect), unless they declare their opposition to the proposal within a certain time limit. Such a clause particularly makes it possible to establish a better contractual basis for the tacit waiver of the preferential subscription right in the event of a new round of financing or a convertible loan (see II.2.b) above).

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[20] The existence of a *lock-up* period is generally considered to be an agreement giving rise to an organized group, and the parties subject to it must be announced as such, pursuant to articles 120 et seq. of the Federal Act on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading of 19 June 2015 (Financial Market Infrastructure Act, FinMIA, SR 958.1) and Article 12 of the Ordinance of the Swiss Financial Market Supervisory Authority on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading of 3 december 2015 (FINMA Financial Market Infrastructure Ordinance, FinMIO-FINMA, SR 958.111).

- Finally, it is possible for all the parties to grant an express power of attorney to a certain person to act on their behalf to perform the obligations under the shareholders' agreement. The representative thus appointed will address all the shareholders before acting on their behalf, so as to give them an opportunity to respond quickly. In the absence of opposition, the representative may act quickly under the provisions of the universal shareholders meeting (*assemblée générale universelle*), in particular without observing the notice period of 20 days.[21] That allows, for example, adjusting the amount of conditional capital for the option plan to the benefit of employees to the percentage stipulated in the agreement, to sign the shareholders' agreement on behalf of those who are unreachable, or to vote on the capital increase necessary to enable a loan conversion.

V. Conclusion

Legal protection of the investor largely depends on negotiation of contractual rights. Such rights, although standardized to a certain extent, still need to be evaluated and adapted to each specific situation. Investors do not all have the same interests and aspirations, their business models and fields of activities vary. In any case, I hope that the above reflections will have helped point out certain practical aspects to be taken into account.

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[21] The Federal Supreme Court held that a waiver of the 20-day notice period for the meeting under CO Article 700(1) was valid only in a specific case, and that a shareholder could not validly waive that period in an abstract way for the future (Federal Supreme Court Judgment 4C.88/2000 of 27 June 2000 c. 2b). For the same reason, I recommend that the representative validate his power of attorney before exercising his rights.

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