DDG
AVOCATS

Acquisition of Startups
/ Act 1

We will be publishing a series of articles on the topic of the acquisition of startups, covering legal, social, and tax aspects, namely:

Acquisition by another startup	Acquisition by a “corporate” entity
Acquisition by a fund via an LBO	The acquisition of a startup in financial distress

In these publications, we will address topics such as due diligence, structuring (share deal, asset deal, equity contributions), price (adjustments, deferred payments, earn-outs), warranties, conditions precedent, and more.

The first post, by way of introduction, focuses on the legal characteristics of startups, which require special consideration in the context of buyout transactions.


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What Is a Startup? Focus on certain legal characteristics

As a preliminary note, we would like to clarify that a number of the points discussed below will pertain more specifically to startups financed by venture capital funds (as opposed to companies developed without recourse to such funds, known as "bootstrapped" companies).

1.

A startup is a company that generally exhibits the following characteristics:

(i) An experimental business model (monetization in progress, partial profitability, potential for a pivot, etc.);

(ii) An ambition to disrupt the market (the startup seeks to reinvent its industry through innovation in products, processes, marketing, etc.);

(iii) Strong growth potential (the startup aims for strong growth in a large market, which is a prerequisite for raising funds);

(iv) A high need for funding (the startup must develop its innovation and will not be immediately profitable, hence the need for significant funding—not in the form of bank debt but rather capital provided by specialized funds and grants).

A "startup" becomes a "scale-up" once it has validated its business model and confirmed its growth potential; at this stage, however, it will often still be financially unbalanced.

2.

In terms of accounting and financial aspects, a startup is generally characterized by a relatively low balance sheet total, primarily intangible assets (technology, software, databases, etc.), little debt (as its financing is mainly equity-based), and revenue but operating losses. The company will also benefit from government incentives for R&D (tax credits, "young startup" status).

The main "asset" of a startup is often its management team (founders with prior successful experience in creating and selling an startup, or researchers from the "innovation" labs of companies such as Google, Meta, or Microsoft).

3.

Logically, the legal characteristics of startups stem from the features identified above, notably ownership of intangible assets, the importance of databases that must comply with GDPR regulations, and a specific shareholder base composed of founders, venture capital (VC) investors, and employees (generally through the granting of stock options…).

4.

Thus, when investors acquire an equity stake in a startup, the valuation remains uncertain (lack of track records, a business plan built on assumptions that may not materialize…), hence the implementation of specific mechanisms designed to protect financial investors, namely:

- "Ratchet" mechanisms, which allow investors to "re-leverage" (i.e., adjust their equity stake upward) in the event of subsequent dilutive transactions based on a price lower than the price of the initial funding round (the mechanism can be structured through stock subscription warrants (BSA) or preferred shares); and
- Preemptive liquidity clauses (see focus below).

Focus on Preemptive Liquidity Clauses

This is a mechanism providing priority payment and/or a differentiated price in favor of investors, which is triggered upon the occurrence of a liquidity event (the "Exit").

This mechanism aims to secure or reward, as the case may be, the issuance premium paid by investors upon their entry into the capital.

This mechanism can be more or less aggressive (non-cumulative preference, simple cumulative preference, cumulative preference with a multiplier). It is generally structured in the form of preferred shares, but may also, for the sake of simplicity, be included solely in the company's shareholders' agreement.

The main types are:

- Non-cumulative preference clauses (known as "non-participating"); in this scenario, investors receive priority payment whenever the price per share in connection with the Exit is lower than their subscription price upon investment.

This is thus a protective mechanism that favors the founders, as it will not apply if the price per share at the Exit is higher than the price at the time of entry. In the latter case, the proceeds from the Exit will be distributed among all shareholders in proportion to the shares sold.

- Cumulative preference clauses (known as "participating" clauses): In this scenario, investors are repaid their investment first, and then the remaining proceeds from the exit sale are distributed among the shareholders in proportion to the securities they hold. This structure favors investors and always results in a differentiated price in their favor.

  Depending on the terms of the transaction, these so-called "participating" clauses may be strengthened (cumulative preference mechanism with a multiplier) or softened (implementation of a catch-up mechanism for the founders).

It should be noted that standard practice typically provides for a first priority tier, which distributes *at least* the par value of the shares to each selling shareholder before proceeding, in the second priority tier, to the preferential allocation. In a structure favorable to the founders, this first priority tier (known as a "carve-out") can reach 15% or even 20% of the proceeds from the sale.

It should be noted that this clause is often the subject of in-depth discussions when the fund invests, given its financial implications. Simulations based on the exit price are generally prepared to illustrate how the clause would be implemented.

5.

A fund's investment implies a future exit, which means that certain conditions and/or terms of the exit are considered from the start of the relationship, notably through:

- the "liquidity clause," that is, the fund's exit horizon and the terms of that exit;
- the "drag-along clause," which, in the event of a tender offer for the entire share capital accepted by a supermajority of the shareholders, compels minority shareholders to sell their shares on the terms of the offer;
- the preferential liquidity mechanism (see above);
- the clause stipulating that the funds will not provide any asset or liability guarantees at the time of the Exit.

These various clauses will be incorporated into a shareholders' agreement, which will typically be structured as follows (since the fund holds a minority stake in venture capital transactions, it will seek not only to establish the terms of its eventual exit but also to implement protection and control mechanisms for as long as it remains a shareholder of the company):

- a section on "Governance" (establishment of a strategic committee, composition, powers, rights to information and audit, etc.);
- a section on "Transfer of Securities" (restrictions on transfer, preemptive rights, exit clauses, etc.);
- a section on "Founders" (exclusivity and non-compete agreements, commitments to sell shares upon departure) and employees (approved incentive plan, model employment contract).

6.

As noted above, the successful development of an startup will largely depend on its founding team and its ability to recruit talent.

As for the founders, they generally retain a significant stake in the company. When financial investors come on board, the founders will need to negotiate the terms of their coexistence within the company (see above).

With regard to employee profit-sharing, the mechanism generally used is BCE (see below).

Focus on BCEs (stock subscription warrants for company founders)

The issuance of BCE is a mechanism for individual employee incentive plans (alongside free shares and stock options).

BCEs were specifically established for young companies to enable them to attract and retain talent, who thereby benefit from the prospect of potentially high returns in the medium or long term, depending on the company's growth. Given how they operate, they also serve as a retention and motivation tool for their beneficiaries.

BCEs thus grant their holders the right to subscribe for shares of the issuing company during a specified period and at a price set at the time the warrants are granted. They therefore offer the prospect of realizing a gain should the value of the issuing company's stock increase.

As a legal mechanism, provided the issuance conditions are met, BCE warrants offer their holders a secure tax and social security regime.

BCE are reserved for companies that meet the following conditions:

- be an unlisted company or a company listed on a European market if its market capitalization is less than 150 million euros;
- have been incorporated for less than fifteen years;
- be a company subject to corporate income tax in France;
- have at least 15% of its capital held directly and continuously by individuals or by legal entities in which at least 75% of the capital is held by individuals (are not taken into account holdings by venture capital mutual funds, specialized professional funds, private equity funds, local investment funds, or innovation mutual funds, as well as holdings by equivalent foreign entities established in a European Union member state or in a country that has concluded an administrative assistance agreement with France);
- not be a company created as part of a merger, restructuring, expansion, or takeover of pre-existing activities, unless all companies participating in the transaction meet the conditions set forth above.

The beneficiaries are the employees and executives of the startup and, under certain conditions, of its subsidiaries.

The exercise of BCEs is generally subject to conditions regarding continued employment with the company ("vesting"), or even performance requirements for the beneficiary managers. Beneficiaries must also sign a contractual commitment (or "mini-shareholders' agreement") and are therefore bound by "drag-along" clauses requiring them to sell their shares in the event of an Exit.

Finally, it should be noted that setting the exercise price of the BCE warrants special attention, as it must reflect the fair market value of the shares issued from said BCE on the date of grant.

The various specific considerations outlined above will require special treatment during the acquisition of the startup; these will be the subject of our upcoming publications.



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