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Authorised capital in private limited companies as structuring instruments in venture capital transactions

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Introduction

With the last reform of German law governing private limited liability companies (GmbH), the instrument of authorised capital as known in the Stock Corporation Act was also implemented in the Limited Liability Companies Act (LLCA) in the regulation of Sec. 55a. The primary purpose of authorised capital shall be to facilitate the financing of the limited liability company through the allocation of new equity capital. The LLCA enables the shareholders to authorise the managing directors of the company for a maximum term of five years to increase the registered capital of the company by issuing new shares against contributions in cash or kind. The nominal amount of the authorised capital may not exceed half of the existing registered capital at the time of authorisation.

The practical relevance of LLCA Sec. 55a, however, has been occasionally questioned in the literature. Due to the generally manageable group of shareholders, in contrast to a stock corporation (*Aktiengesellschaft*), it is usually possible to duly procure an increase in share capital without delays. This argument is fundamentally understood; however, it is often not applicable to companies financed with venture capital that have several shareholders from different jurisdictions. In view of this fact, authorised capital definitely represents an interesting structuring instrument.

How to protect the investor?

The shareholders' meeting is generally free to issue further directives with regard to the authorisation, in addition to the mandatory

specifications pursuant LLCA Sec. 55a. These may include additional responsibilities, as well as restrictions on the fundamental options of the managing director's actions. If, within the scope of a venture capital transaction, authorised capital is created in the target company, one may commonly observe that the managing directors are not given unrestricted competence with regard to the full utilisation of authorised capital. In the course of his participation in the target company, a venture capital investor will always ensure that certain structural measures may not be determined by the shareholders' meeting without his consent. In view of a possible dilution of his participation, a venture capital investor will be particularly prudent in order to ensure that the group of shareholders may not be expanded by issuing new shares without his prior consent. From the viewpoint of the venture capital investor, it may also be prudent to recognise restricted specific functions and to specifically define in the authorisation for which purposes the share capital increase from authorised capital may be carried out.

Admission of further investors

The authorisation may provide, for example that the authorised capital may only be utilised for the purpose of including a certain investor. This may be particularly appropriate if, in addition to a venture capital provider, a public business development bank such as *Kreditanstalt für Wiederaufbau* co-invests in the target company. Investment decisions of public business development banks are often subject to the panel approval of an investment committee. If the decision by the necessary panel cannot be promptly procured, the participation agreement often provides that the lead investor shall subscribe for shares within a first capital increase and the shareholders are obligated to resolve upon a further capital increase to include the co-investor (second closing) later on. Instead, the participation of the co-investor may also be carried out through full utilisation of authorised capital.

By specifically limiting the purpose of the authorisation to the inclusion of the co-investor, the lead investor is sufficiently protected.

Employee participation

In addition, the implementation of authorised capital in order to exercise option rights from an employee participation program is also a possibility. However, in practice this is not often recommended. Among the disadvantages is, on the one hand, the only five-year authorisation period, whereby tight time limits are imposed on the holding and exercise of option rights. On the other hand, one must take into consideration that the membership rights do not arise with the exercise of the option or the full utilisation of the authorised capital, but at the time of the registration of the capital increase in the commercial register of the company. The implementation of authorised capital may nonetheless make sense in such cases in which the shareholders' meeting wishes to re-serve the possibility of direct participation by members of the management or other employees of the company at a later date.

Safeguarding conversion rights

While safeguarding the conversion right of the limited liability company before the introduction of authorised capital was possible based solely on an agreement between all shareholders, it is now possible to also illustrate the claim for issuance of the respective shares according to the articles of association by way of the implementation of authorised capital. However, in view of the unlimited authority of the shareholders' meeting, for the protection of the venture capital investor a shareholder obligation should still be implemented in the participation agreement or the convertible loan agreement. In addition, the articles of association should provide for a qualified majority and/or consent requirement by the venture capital investor for instructional resolutions of the shareholders'

meeting with regard to the full utilisation of the authorised capital.

Conclusion and outlook

One can agree with the critics of authorised capital that this new organisational instrument will probably not become as important for the limited liability company as it is for the stock corporation. Nevertheless, this new instrument certainly has the potential to gain more of a foothold in venture capital practice upon consideration of the previously mentioned models. Therefore, participation agreements already allow in practice for more obligations of former shareholders to establish authorised capital. In particular with regard to the admittance of further investors, the direct participation of employees, as well as the representation of conversion rights, authorised capital can represent a flexible, timely and extremely efficient structural instrument.