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Structuring Venture Capital Investments

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Considering the high risks of venture capital investments, investors hope for outsized gains. To make that possible, the investment is normally structured in a way that gives the investor a preference in receiving back all or most of its funding and the right to participate in the incremental profits jointly with the other shareholders on a *pro rata* basis.

In the United States this structure is usually achieved through the issuance of participating preferred stock or convertible notes (or a combination of both), or similar contractual arrangements.

The participating preferred stock (also called “double dip” preferred stock) entitles its holder to an amount equal to the original investment (or its investment plus a specified yield) upon a liquidation event (merger, acquisition or liquidation). It also typically grants to its holder a *pro rata* share of the residual proceeds corresponding to the amount the preferred stockholder would have received on an “as converted” basis (thus the “double dip” nickname). Additionally, such preferred stock usually converts into a number of common shares in case of an exit through an IPO and in other specified events.

The convertible note, in turn, is usually adopted in early stage investments because of the difficulty in agreeing on the start-up’s valuation; or to provide a bridge loan where banks are not ready to fund the start-up. The conversion ratio is usually established taking into account a percentage discount over the valuation of the company in a subsequent financing round (in some cases, up to a negotiated ceiling).

Both structures allow the investor to negotiate protective provisions. Under a participating preferred stock structure, the investor may enter into a shareholders’ agreement with the founders providing for the appointment of a number of directors, a certain level of control over subsequent rounds of financing and exit strategies. In a convertible note structure, the notes indenture can include negative covenants and early liquidation events.

Similar structures may also be implemented in venture capital investments in Brazil. A Brazilian corporation (*sociedade anônima*) may issue preferred stock with full, limited or no voting rights[1], entitled to the priority payment of fixed dividends or minimum dividends (which allow the preferred stockholder, after receiving the minimum amount due, to participate in the residual proceeds), and a priority in the reimbursement of capital in case of dissolution or winding-up of the corporation. The start-up’s by-laws and shareholders’ agreements can secure the right to appoint a number of directors, veto rights, as well as several other protective measures similar to those that may be attributed in the United

[1] Preferred non-voting shares (or shares with restricted voting rights) may not surpass 50% of the corporation’s total number of shares.

States to a preferred stockholder. The by-laws may also grant the preferred stockholder the right to convert the preferred stock into common shares. Also, akin to the convertible note structure used by U.S. firms, a Brazilian corporation can issue secured or unsecured convertible debentures. And the debenture deed can include negative covenants and early liquidation events.

The majority of business enterprises in Brazil, though, are incorporated as limited liability companies (*sociedades limitadas*). The main reason for the widespread use of limited liability companies is their simpler organization. This simpler organization, combined with some restrictive rules imposed by law, prevents or puts forth more challenges for the use of the venture capital structures discussed in this article.

A limited liability company's capital stock is divided into quotas. It is generally understood that the company cannot issue preferred stock. To circumvent this restriction, the company's articles of association can establish that the profits will be distributed disproportionately from the share of each quotaholder in the company's capital stock. However, this alternative may not be sufficient to accommodate all of the complexities of a venture capital structure. The broad rights conferred upon the quotaholders to withdraw from a *sociedade limitada* in general brings a high degree of instability.

The law also establishes that a supermajority vote is required for the approval of certain matters in limited liability companies, which can in many cases immobilize the company.

There is also a heated debate as to whether limited liability companies are allowed to issue debentures. Some of the main Registries of Commerce in Brazil hold the view that issuance of debentures by *sociedades limitadas* is illegal.

Finally, it is worth noting that the most used vehicles for venture capital investments in Brazil are the FIP – *Fundo de Investimento em Participações* and the FMIEE – *Fundo Mútuo de Inestimento em Empresas Emergentes*. And the regulations applicable to both these funds do not allow investments in limited liability companies, only in corporations.

Thus, while there are contractual arrangements that may be put in place in a *sociedade limitada* (*e.g.,* issuance of a promissory note) to accommodate venture capital investments, in many cases it will be necessary to transform the start-up into a corporation before the investment is made so that the investor is able to have the appropriate degree of protection to enter into such a risky venture.

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