France

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MARKET

1. Please describe briefly the venture capital market in your jurisdiction, in particular:

- **How it is distinguished from private equity.**
- **The sources from which early-stage companies obtain funding.**
- **The types of companies that attract venture capital investment.**
- **Market trends (for example, levels of investment, the type of companies invested in and where those companies are located).**

Venture capital and private equity

Capital investment (*capital investissement*) generally refers to investment in unquoted companies, including:

- Venture capital.
- Growth capital.
- Leveraged buyouts.
- Turn-around funds.

Venture capital covers investments in start-up or developing innovative companies with little or no cash flow, but strong growth potential. Private equity typically involves investment in more mature businesses.

Sources of funding

The funds invested in capital investment during the first half of 2009 came from (*Grant Thornton and the French capital investment association, Association Française des Investisseurs en Capital (AFIC) (www.afic.assoc.fr)*):

- French sources: 82%.
- European sources: 18%.
- The rest of the world: 0%.

Investment principally comes from:

- Banks.
- Insurance companies.
- High net-worth individuals.

Contributions by high net-worth individuals are likely to increase due to tax incentives (*see Question 2*).

Types of company

Venture capital investments focus on companies operating in the technology sector, particularly:

- Internet.
- Software.
- Hardware.
- Telecommunications.
- Life sciences.

More recently, venture capital funds have expressed a strong interest in cleantech and energy infrastructures.

Market trends

In the first half of 2009, venture capital funds invested EUR358 million (about US$527 million) (involving 237 investments in companies) compared to EUR758 million (about US$1,115 million) (comprising 428 investments in companies) in 2008 (*Grant Thornton and AFIC*).

There is often a shortage of seed investment, which means that start-up companies often apply for subsidies (*see Question 2*).

Despite the credit crunch, venture capital funds appear willing to actively invest, particularly through funds benefiting from tax incentives (*see Question 2*) (*report by Aelios Finance, January 2009, available at http://aeliosfinance.typepad.com/files/le-barom%C3%A8tre-aelios-finance-janvier-2009.pdf*).

2. What tax incentive schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

Investment funds scheme

Individual investors can benefit from a social security and favourable tax regime if they invest in specific types of funds including:

- ***Fonds communs de placement à risques* (FCPR).** To qualify for favourable tax treatment, at least 50% of the assets of an FCPR must be invested, directly or indirectly, in non-listed EU-resident companies that carry out commercial or industrial activities and are subject to local corporate income tax. These qualifying assets can include listed companies with a market capitalisation of less than EUR150 million (about US$221 million), but only up to 20% of the total assets. Qualifying assets can also include investment in funds, whether located in France or not, which mainly invest in EU companies that are unlisted or listed with a small capitalisation.

- ***Fonds communs de placement dans l'Innovation* (FCPI).** An FCPI is a type of FCPR dedicated to investments in innovation. To qualify for favourable tax treatment, at least 60% of the assets of the FCPI must be invested in innovative companies established in the EU and subject to local corporate income tax. Qualifying assets include listed companies with a market capitalisation of less than EUR150 million with no restrictions for companies listed on a non-regulated stock market and only up to 20% of the total assets for companies listed on a regulated stock market.
- ***Fonds d'investissement de proximité* (FIP).** A FIP is a type of FCPR dedicated to local or regional investments. To qualify for favourable tax treatment, at least 60% of the assets of the FIP must be invested in EU non-listed companies, which must be located in up to a maximum of four different geographical regions geographically connected together in France or in the EU. The qualifying portfolio must invest at least 10% of its assets in newly created companies.
- ***Sociétés de capital risque* (SCR).** SCRs are holding companies investing at least 50% of their total assets in non-listed companies in the same manner as FCPRs.
- **ISF holding companies (special wealth tax (*impôt sur la fortune*) vehicle).** These are holding companies, unlisted on a stock market, which have raised funds from French individual investors. They must invest a large portion of their assets (around 80% to 90%) in securities of small- or medium-sized companies (SMEs) that are unlisted or listed on a non-regulated stock market.

Individuals investing though FCPRs, FCPIs, FIPs or SCRs can benefit from an exemption from French tax on income distributed and on capital gains realised on the sale of shares in the fund or securities of the SCRs when all the following apply:

- They have not sold or redeemed their units in the fund or securities in the SCRs before a five-year restricted period.
- They have reinvested in the funds or SCRs all distributions received from them during the same five-year period.
- The individual investor does not hold more than 25% of the shares of a company included in the fund's portfolio of investments.

French companies investing through FCPRs or SCRs can benefit from 0% or 15% corporate tax on long-term capital gains received from the fund or the SCR, or realised on the sale of securites of the SCR (depending on how long the fund has been invested in the company (more or less than two years)) if they do not sell or redeem their units in the fund or securities in the SCRs before the five-year restricted period.

Individuals investing can also benefit from the following tax reductions:

- If they invest in a classic FCPI or FIP, an income tax reduction equal to 25% of the amount invested in the funds up to EUR12,000 (about US$17,700) per person, and EUR24,000 (about US$35,300) for a couple (that is a maximum tax reduction of EUR3,000 (about US$4,400) per person or EUR 6,000 (about US$8,800) for a couple).
- If they invest in a special FCPR, FCPI or FIP dedicated to investment in securities of European SMEs, unlisted on a regulated market, a wealth tax (*Impôt de Solidarité sur la Fortune*) (ISF) reduction equal to 75% of the amount invested up to EUR66,667 (about US$98,100) per person or for a couple.

However, French residents remain liable to social security contributions at 12.1% on the proceeds received from the unit redemption from those funds or SCRs.

Favourable tax regime for investors

Certain investments in French or EU-resident SMEs benefit from income tax and wealth tax advantages, where the investments are:

- Made directly or through a holding in unlisted SMEs subject to local corporate income tax.
- Held for a minimum five-year period.

If so individual investors can benefit from:

- An income tax reduction equal to 25% of the amount invested, up to EUR50,000 (about US$73,600) and EUR100,000 (about US$147,100) for a couple, if the company meets conditions to be considered as a very small enterprise.
- A wealth tax exemption and/or reduction equal to 75% of the amount invested up to EUR50,000 per person or for a couple.

Favourable tax regime for SMEs

Tax incentives, such as tax research credits, are available to support and encourage the development of innovative companies. In addition, an attractive tax and social security regime applies to innovative newly-created companies (*Jeune Entreprise Innovante*) (JEIs), which are SMEs dedicating more than 15% of their total expenses to research and develoment. JEIs can benefit from:

- A total exemption for the first three profitable years, and a partial exemption (50%) for the following two profitable years, from social security contributions and corporate income tax.
- An exemption from business tax for the first seven years (under certain conditions).

Public incentives

Subsidies for SMEs are available from Oséo (*see website, www.oseo.fr/oseo/oseo_in_english*), a public agency aiming to provide assistance and financial support to French SMEs in the decisive phases of their life cycle, including:

- Start up.
- Innovation.
- Development.
- Business transfers or buyouts.

3. From what sources do venture capital funds typically receive funding?

Venture capital funds typically receive funds from:

- Financial institutions and insurance companies.
- Private high net-worth individuals.
- French government and European agencies.
- Pension funds.
- Corporate investors.

In 2008 and 2009, French individuals investing in private equity fund such as FCPIs or FIPs with a 75% wealth tax reduction, represented a large portion of funds raised by French funds.

4. Can the structure of the venture capital fund impact on how investments are made?

Investment quotas that apply to regulated funds, as well as their assets and liabilities constraints (*see Question 2*), can affect the way investments are structured.

The type and duration of investments also depends on whether the fund is an undertaking for collective investment in transferable securities (UCITS). UCITS must, with few exceptions, give investors the right to sell their shares and must be an open-ended fund (as opposed to a closed-ended fund).

5. Do venture capital funds typically invest with other funds?

French venture capital funds generally co-invest with other funds, both French and foreign.

FUND FORMATION AND REGULATION

6. What legal structure(s) are most commonly used as vehicles for venture capital funds in your jurisdiction?

The majority of venture capital investors use FCPRs, FCPIs or FIPs because these legal structures are tax neutral. In addition, as FCPRs, FIPs and FCPIs are regulated funds (non co-ordinated UCITs), and are therefore supervised by the financial regulator (*Autorités des marchés financiers*) (AMF), investors have a degree of protection and transparency that other types of vehicles do not provide.

There are two categories of FCPRs:

- FCPRs that are offered to subscription by private individuals (such as FCPIs or FIPs), for which an AMF agreement is required.
- FCPRs called *alleges*, dedicated to institutionals investors only.

The constraints, in terms of prudential ratios (ratios of capital to assets) and investment policy, applicable to FCPRs *allégés* are less strict than for FCPRs with prior approval by AMF.

In 2008, legislation created a new sub-category of FCPR known as contractual FCPRs. Contractual FCPRs do not have to respect investment ratios, or prudential ratios. They are less regulated than usual FCPRs. FCPRs *allégés* are exclusively dedicated for qualified investors and accredited investors only. The setting up of FCPRs *allégés* or contractual FCPRs is faster, because a special licence is not required from the AMF.

A contractual FCPR's management company can make any type of investment (subject to certain conditions if the investment is not made in shares), provided it invests in a portfolio of unlisted companies (although it can invest in funds of funds). Contractual FCPRs have less regulatory contraints than FCPRs *allégés*.

7. Do a venture capital fund's promoter, manager and principals require licences?

FCPRs, FIPs and FCPIs can only be created and managed by regulated management companies, which must have a special licence granted by the AMF. These funds must also have a custodian for their assets, which must be a financial institution.

There are no other licensing requirements.

8. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions? Include, in the answer, any restrictions on how a venture capital fund can be marketed or advertised (for example, under private placement or prospectus rules).

Legal structure

Venture capital funds are mostly UCITs and are therefore regulated and supervised by the AMF (*see Question 6*).

Venture capital funds which are companies, as SCRs, are not regulated but must comply with special tax regulation.

Marketing

The marketing of FCPRs, FIPs and FCPIs, SCRs and holding companies is regulated by the same rules as the marketing of other financial instruments, including the rules on public offerings and private placements. In public offerings, a visa from the AMF is required before any shares are offered for subscription.

Contractual FCPRs cannot make a public offering of securities, and can only market their shares to qualified investors or accredited investors.

9. How is the relationship between investor and fund governed? What protections do investors typically seek?

The relationship between investor and fund is governed by the fund's general regulations (that is, its organisational document), which are not normally very detailed since the UCITS structure required for most funds provides investors with a clear legal framework.

However, certain provisions are often required by investors either in the fund's general regulations or in their individual subscription agreement, concerning:

- Information rights.
- Participation in certain investment committees.
- Mandatory redemption if key personnel leave.

10. What are the most common investment objectives of venture capital funds (for example, what is the average life of a fund, what return will a fund be looking for on its investments and what is the time frame within which a fund would seek to exit its investment)?

Most venture capital funds have a term of eight to 12 years. Typically, venture capital funds look for returns of 20% per year and expect to exit an investee company within five years of the initial investment, although in practice an exit takes an average of seven to eight years.

11. Are there any recent or proposed regulatory changes affecting the venture capital industry?

The legal provisions applicable to the tax regime of the carried interest to be paid to venture capital funds' general partners living in France have recently been amended. When the legal conditions to be satisfied for the most favorable regime are not met (in particular, the minimum amount of investment to be made by general partners in the funds, between 0.25% and 1% of the size of the funds, depending on the type of fund), then the carried interest may be subject to regular income tax and social contributions in the same way as wages.

There have been two different attempts to approve a new legal provision that would require all funds (FCPIs, FIPs and FCPRs) benefitting from a tax reduction in favour of private individual investors, to complete all their fund investments within one year after their fund raising, and not within two and half years (under the current position). These attempts have raised significant concerns and protests from venture capital professionals.

INVESTMENTS

12. What form of investment do venture capital funds take? (For example, equity, debt or a combination.)

Venture capital funds invest by subscribing for equity with preferred rights (*actions de preference*). French legislation relating to issuing preferred shares has become more flexible over the past five years.

Preferred shares generally bring financial and non-financial rights (*see Question 17*) and are convertible into ordinary shares, either:

- At their holders' request.
- Automatically on an exit or initial public offering (IPO) if the transaction exceeds a pre-agreed value.

Recently, venture debt has become available in France, but is mainly provided by UK-based funds (except for one newly formed fund in France in 2009). The recent creation of contractual FCPRs (*see Question 6*), with little regulatory constraints, should encourage the development of venture debt.

13. How do venture capital funds value an investee company?

Since the investee company generally has no cash flow, the valuation methods used for more mature companies are normally inappropriate. Instead, investee companies are valued on the strength of their business plan, which depends on the:

- Management and its capability to achieve the business plan.
- Size and attractiveness of the target market.
- Competitive advantage of the company in the target market, looking at barriers to entry, patents, exclusivity, time to market and other factors.
- Company's stage of development.

14. What investigations will venture capital funds carry out on potential investee companies?

Venture capital funds evaluate their investment risk by carrying out due diligence on an investee company, on the following issues:

- Business.
- Accounting.
- Legal.
- Tax.

In certain venture capital investments, where development potential is subject to their patent and trademark portfolios, intellectual property due diligence is often particularly important.

15. What are the principal legal documents used in a venture capital transaction?

As French funds frequently co-invest with foreign funds, the contractual documentation is often in English. It typically includes:

- A subscription agreement under which the venture capital investors agree to subscribe for preferred shares subject to certain condition precedents and covenants on the management team, generally containing both:
  - representations and warranties for the benefit of the venture capital investors concerning the investee company and its business (*see Question 16*);
  - non-compete covenants from founders and management shareholders (*see Question 16*).
- A shareholders' agreement, governing the relationship between venture capital investors and other shareholders (founders, business angels, managers), generally including:

- the right to board (*conseil d'administration*) representation;
- consent rights in relation to certain corporate and business significant actions;
- information rights;
- liquidation preference rights;
- anti-dilution rights;
- drag-along rights;
- full or proportionate tag-along rights;
- first refusal or pre-emption rights on the transfer of shares to other shareholders or to third parties;
- pre-emption rights on the issuing of new shares;
- good and bad leaver covenants on managers;
- buy or sell clause, and/or liquidity clauses.

Some of these rights may be also attached to the preferred shares and consequently duplicated in the articles of association (*statuts*) of the company, which are generally deemed to increase their enforceability.

Drag-along and first refusal or pre-emption obligations are imposed on company employees that receive incentive shares or securities (*see Question 24*). In exchange, the employees are generally offered full tag-along rights. These rights are contained in a separate agreement entered into by the employees when the incentive shares or securities are granted. Although French law requires all legal documentation entered into with French employees in the context of their employment to be in French, French courts have recently held that obligations contained in a share option plan in English were enforceable against a French employee, when it was established that the employee was fluent in English (*French Supreme civil court, 16 May 2007*).

16. What form of contractual protection does an investor receive on its investment in a company?

A venture capital investor typically receives the following contractual protections on its investment:

- Representations and warranties from the investee company and founder or manager shareholders, in connection with the investee company and its business. These representations and warranties are generally perceived as due diligence, rather than an effective remedy, because an indemnification by the investee company is usually of little value to its investors. However, the indemnification obligation is questionable under French law, which prohibits an issuing company from granting a guarantee in connection with a subscription to its own shares (*article L 225-216, French Commerce Code*). In addition, individuals' (founders or managers) indemnification obligations are generally limited to the assignment of their shares and forfeiture of their unvested securities to the venture capital investors.
- Non-compete covenants and good/bad leaver clauses from founder or management shareholders.
- Liquidation preferences and anti-dilution protections (*see Question 17*).

17. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

Typically, venture capital funds invest by subscribing for preferred shares. These may be automatically converted into ordinary shares in certain circumstances (including an exit or IPO).

Founders and employees typically receive ordinary shares.

18. What rights does a fund have in its capacity as a holder of preferred shares (for example, what rights to capital and/or to interest)?

A venture capital investor holding preferred shares typically has the following rights:

- Liquidation preference rights (that is, the right to be paid up to a certain amount (generally the amount, or a multiple, of its investment)), in priority to the holders of ordinary equity, on an exit or on the liquidation of the investee company.
- Right to appoint a director (*administrateur*) to the board or a member of the supervisory board (*conseil de surveillance*). Smaller investors can be granted the status of observer (*censeur*) with no voting rights.
- Consent rights in relation to certain corporate and business actions, which should not be too extensive for liability reasons (*see Question 19*).
- Anti-dilution protection, which compensates for the uncertainty of the company's valuation at an early stage. Anti-dilution protection may be full or weighted average ratchet.

19. What rights are commonly used to give a fund a level of management control over the activities of an investee company (for example, board representation, certain acts of the company subject to investor consent)?

A venture capital investor usually requires the right to appoint one or more directors or observers to an investee company's board, and to remove and replace these appointed persons. The quorum may be increased to ensure that a majority of directors appointed by venture capital investors participate in board decisions.

Certain acts of the company are generally submitted for prior investor consent. Consent often requires a qualified majority of investors if there are co-investors.

French law does not allow for non-executive directors. All directors are subject to the same duties and liabilities. Breach of their duty to supervise the company can result in joint or personal liability. This duty requires directors to:

- Actively participate in the board meetings.
- Keep control over the administration of the company.
- Enquire into any difficult financial situation encountered by the company.

Directors can be jointly liable for decisions made by the board.

In addition, if investors (whether officially acting in the capacity of a director or not) actively participate in the management of the company, they may be found to be a de facto manager, which entails specific liabilities. If the company is subject to insolvency proceedings, a manager or de facto manager can be held liable for the company's debts if his acts of mismanagement caused or contributed to the insolvency. Further, a de facto manager can be deemed as the employer of the investee company's employees, and would then bear related liabilities, particularly if the investee company is insolvent and/or lays off employees. Therefore, consent rights must be reasonably restricted to limit the risk of the investors being regarded as de facto managers.

20. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

The founders and managers are generally required to hold their shares until an exit is achieved. There are a number of customary exceptions (such as transfer to an heir or to a wholly-owned company). In addition, they may be allowed to transfer a limited percentage of their shares during the restricted period. Transfers, when permitted, are subject to the other shareholders' pre-emption rights.

21. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company (for example, drag-along and tag-along rights)?

Venture capital investors typically have drag-along and tag-along protection.

A drag-along clause generally provides that if venture capital investors holding a determined percentage of preferred shares wish to accept a bona fide offer for all investee company shares, they can oblige the other shareholders to sell their shares in the sale.

The are two types of tag-along protection:

- A proportionate tag-along provision that only benefits the venture capital investors. Investors are given the right to block the sale of any shares by any other shareholder to a third party, unless that third party also agrees to buy equivalent portions of the investor's shares at the same price.
- A full tag-along that benefits all shareholders. This generally allows a shareholder to join in a sale by other shareholders to a third party if the sale entails a change of control or if the third party is an industrial investor.

22. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

There is generally a contractual pre-emption right for any further issues of shares by an investee company, in addition to the statutory pre-emption right applicable under French law (*droit préférentiel de souscription*). Under the contractual pre-emption right, shareholders cannot issue shares without first offering them to the venture capital investors allowing them to maintain their current percentage holding in the company's share capital.

23. What consents are required to approve the investment documentation?

The investee company's structure and organisational documents determine what type of approval is required. The investment itself (that is, an issue of preferred shares) generally requires both:

- A shareholder resolution to be passed at an extraordinary general meeting.
- An appraisal by a court-appointed auditor (*commissaire aux avantages particuliers*) who issues a report to the general meeting of the shareholders on the rights to be attached to the preferred shares to be issued in favour of the investor.

24. Who covers the costs of the venture capital funds?

Transaction costs incurred by venture capital investors are generally covered by the investee company, which then receives a copy of the due diligence materials.

FOUNDER AND EMPLOYEE INCENTIVISATION

25. In what ways are founders and employees incentivised (for example, through the grant of shares, options or otherwise)? What are the resulting tax considerations?

As employment income is subject to progressive income tax rates up to about 40% and additional social security contributions, founders and employees are generally incentivised through the grant of free shares (*actions gratuites*) or options giving them the right to subscribe for shares (share options or warrants such as *bons de souscription de parts de Créateur d'Entreprise*). These incentivisation schemes have a vesting period before they can be exercised, and are subject to good leaver and bad leaver provisions.

Only employees and certain managers can receive the following shares and options benefiting from the favourable tax and social security regime (subject to certain conditions):

- **Stock options.** The favourable tax and social security regime applies if the grantee holds the shares resulting from the exercise of their options for four years from the date of grant (the holding period). The acquisition gain is then subject to both:
  - individual income tax at a flat rate of 30% up to EUR152,500 (about US$224,300) and 40% for the remaining portion;
  - social security contributions at 14.6%.

  Lower rates apply if the shares are held for an additional two-year period following the holding period.

  The capital gain on the disposal of these shares is subject to both:
  - individual income tax at a flat rate of 18%;
  - social security contributions of 12.1%.

- **Free shares.** The favourable tax and social security regime applies to free shares that are held for a minimum four-year period. The acquisition gain is then subject to both:
  - individual income tax at a flat rate of 30%;
  - social security contributions at 14.6%.

  The capital gain on the disposal of these shares is subject to:
  - individual income tax at a flat rate of 18%;
  - social security contributions of 12.1%.
- ***Bons de souscription de parts de Créateur d'Entreprise* (BCE).** BCEs are warrants to acquire shares at a pre-determined price. Companies can only issue BCEs if:
  - they are established in France and have existed for less than 15 years;
  - at least 25% of their share capital is held directly or indirectly by individuals.

  If the beneficiary has been employed by the issuing company for at least three years when the shares are sold, a capital gain realised on the sale of the shares acquired as result of the exercise of the BCE is taxable at a flat rate of 18%, plus social security contributions of 12.1%. Otherwise, the capital gain is subject to individual income tax at a flat rate of 30%, plus social security contributions of 12.1%.

A founder with a minority shareholding can also benefit from a favourable tax regime when it is held through a specific account (*plan d'épargne en actions*) (PEA). Capital gains held in a PEA are exempt from individual income tax under certain conditions, such as a five-year holding period.

26. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture (for example, good leaver/bad leaver provisions and restrictive covenants)?

Good leaver or bad leaver protections applying to the equity and/or options held by founders and non-compete covenants are common. Non-compete covenants must be reasonably limited to be enforceable. In addition, if the founders and managers are also company employees, they must receive compensation for their non-compete covenant.

EXITS

27. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Exits from an unsuccessful portfolio investee company are usually achieved through a sale or liquidation of the company.

If the company is insolvent, its liquidation may expose investors, as directors or de facto managers, to personal liability (*see Question 18*).

28. What forms of exit are typically used to realise a venture capital fund's investment in a successful company (for example, trade sale, initial public offering and secondary buyout)? What are the relative advantages and disadvantages of each?

Successful exits consist generally of:

- Trade sales.
- Secondary sales to other venture capital or private equity funds.
- IPOs.

Given the current recovery of financial markets, a certain number of IPOs are expected to take place in 2010.

29. How can this exit strategy be built into the investment?

Venture capital investors normally contractually agree that if an exit has not been achieved after a specific period (typically, five to six years), they retain the right to instruct an investment bank on behalf of all shareholders to start a sale process which should lead to an exit.

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