LOBO & IBEAS
ADVOGADOS

Stop-loss Mechanisms in Venture Capital Deals

Gabriel Rios Corrêa

Venture capitalists search for start-ups and small businesses with high growth prospects. Be it in Brazil, in the United States or elsewhere, the investment is usually structured in a way to allow the investor to receive back its funding and to benefit from incremental profits through preferred dividends and eventually through an IPO or a trade sale. Venture capital investments may generate high yields, but they are also highly risky. There is no guarantee that the target company's value will increase. There is also no guarantee that there will be sufficient liquidity for an IPO or a trade sale within the time frame expected by the investor. The investor may face the risk of losing all of the investment made.

Where the venture capitalist has more leverage, he can negotiate a stop-loss mechanism. One that is often adopted in venture capital deals, subject to the applicable law, is the mandatory redemption. Under a typical mandatory redemption provision, the company redeems the investor's stock for the original investment amount or another previously agreed value after a certain period of time or upon the occurrence of designated events.

The mandatory redemption as an exit strategy was used, for example, by the private equity funds Apax Partners LLP and TPG Capital Management LP in 2005 when they acquired convertible preferred equity certificates issued by Hellas Telecommunications in a leveraged buyout transaction. In the following year, due to the company's severe financial situation, they exercised their right under the mandatory redemption provision and sold back to the company the acquired equity[1].

In Brazil, the company's bylaws may authorize the redemption of shares and establish the conditions of such redemption. Alternatively, the shareholders can agree in a shareholders' agreement that, after a period of time or upon the occurrence of certain events, at the investor's request they will vote in a shareholders' meeting to approve the redemption of his shares.

There are some hurdles, however, to the use of redemption mechanisms in venture capital investments in Brazil. First, according to the Brazilian Corporations Law, all shares of the same type (common or preferred stock) or class shall be simultaneously

---

[1] More details at: http://m.jonesday.com/foreign-representative-lacks-standing-to-assert-state-law-avoidance-claims-in-chapter-15-case-03-31-2015/

redeemed. If that is not possible, the shares to be redeemed will be selected by lottery. In order for the redemption mechanism to properly work as stop-loss strategy, the venture capitalist must hold all shares of a certain type or class. In addition, a company has to pay for redeemed shares with its profits or reserves[2]. Considering that it usually takes a number of years before a start-up becomes profitable and that a stop-loss mechanism is likely to be triggered when the company is at a loss, it is improbable that during such period the company will have garnered profits or reserves to redeem the shares. To circumvent this issue, an alternative would be to have a portion of the investment made by the investor in the company allocated as capital reserve (instead of as capital stock). Such portion could then be employed in the future in the redemption of shares. An alternative defended by some jurists but subject to controversy[3] would be to reduce the company's capital stock in an amount sufficient to absorb any existing losses and to create the reserves to be used for redeeming the shares. This second step would only be effective 60 days after the publication of the relevant minutes of shareholders' meeting approving the reduction and provided that none of the company's creditors challenges it.

Considering the difficulties in implementing a redemption provision in Brazil, an alternative stop-loss mechanism is a put option against the company's founders, set forth in the shareholders' agreement. A put option such as this will usually provide that, after a certain period of time or upon the occurrence of certain conditions (*e.g.*, the company's debt exceeding a certain figure or 'x' times the value of the assets), the investor will have the right to sell to the founders, and the founders will have the obligation to purchase from the investor all of his shares for a pre-determined price (*e.g.*, the original investment amount plus/minus a certain margin) or the shares' fair value. Depending on the assets and nature of the start-up, it may be hard to assess the fair value of the shares, and, therefore, advisable to adopt a pre-determined value.

These mechanisms could vary significantly from deal to deal and an investor with considerable bargaining power could possibly negotiate a combination of the two stop-loss provisions. The yield is not guaranteed, but at least the investor will have some assurance that he will be able to get back a portion of the invested amount.

***

Gabriel Rios Corrêa *is a partner at Brazilian law firm Lobo & Ibeas Advogados. He has a Master of Laws from the New York University.*

[2] Except for the legal reserve (*reserva legal*), which may only be used for offsetting losses or increasing the capital stock.
[3] The Brazilian Corporation Law does not expressly set forth that the capital stock can be reduced to create reserves. In a recent case, the Brazilian SEC, CVM, has held that the company cannot reduce its capital stock to create reserves.