Leaver and Vesting Provisions

- German Market and Legal Perspective -

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The following brief comments are based on the "Insights" Paper **"The good, the bad and the ugly: a practicle guide to negotiating leaver and vesting provisions" by Humphreys Law Limited**,
London: https://humphreys.law/insight/ and highlight only the main differences in Germany compared to the UK.

Market Dynamics and Legal Framework

For many years, the M&A activity in Germany has been very strong and increased significantly, both, for national deals, as well as for cross-border deals. Some of the reasons of the strong M&A market in Germany are foreign investors who see Germany as the strongest economy in the EU as an entry-point into the European market, and the "awakening of the sleeping beauty" of the German Start-up scene. It is therefore relevant to understand the main principles of investing in German companies, in particular the protection of that investment against "bad leavers", and the applicable law.

Investors in Germany often use the avenue of convertible debt instruments to invest in start-ups. The start-up scene in Germany is strongly on the rise, in particular in Berlin, but also in other parts of Germany. In or around Munich, for example, you will find most of the high tech companies that are domiciled in Germany.

Since German law is largely defined by statutory law, unlike the UK common law, such statutory law provides the framework of leaver provisions in investment and

shareholder agreements. Within that legal framework however, there is extensive contractual freedom in the design of equity or debt instruments of participation.

Some of the relevant statutory laws to be considered include the laws pertaining to companies (Sec. 705 et. seqs. Civil Code (BGB); the Code for limited liability companies (GmbHG); Code for Trade and Associations of Persons (HGB); the Code for Public Shareholding Companies (AktG); the Code for the Transformation of a company (UmwG); Insolvency Law (InsO). In addition, the Code for Protection of Employees against unfair dismissal (KSchG) is relevant for employee benefit agreements.

The limited liability company (GmbH) is the most relevant corporate form in Germany since its inception in 1892.

Leaver Options

The investor can freely negotiate leaver options with the founders or the management (at the time of an MBO), as long as the counterpart is not qualified as an employee and therefore may be protected by statutory law against unfair dismissal (KSchG), and within a few limits of statutory law.

Restrictions of employee protection laws are generally only relevant in cases of Employee Stock Ownership Programs. The KSchG protects only employees - not a director or part of the management - of a private company with 10 or more employees after six months of employment.

Therefore, investment agreements with start-ups and with the representatives of the company are typically not restricted by employment protection law. However, inter-company agreements with its employees that are related to ESOP incentive schemes must follow that law with the result that the bonus shares of employees may only be confiscated from “bad leavers”, subject to a compensation.

Tax implications must be regarded separately, both, for corporate and for individual taxes in such cases. In principle, however, participation agreement are not considered to be (partial) profit transfer agreements.

An investor, regardless whether it is a fund or a VC, requests the founders of a company to reserve a portion of their shares for contribution of their shares to the ESOP. In addition, the key management staff will be incentivised to stay on board in a way described below. Often, the key staff would be the founders of the

company with their respective corporate functions. Therefore, it is strongly advisable to regulate the leaver options in the shareholder agreement, respectively in the terms of the investment agreement and the articles of association.

1. Vesting Period

All shares of the founders vest over a specific period of time, typically not under five years, dependent on the commercial status of the company. Founders are permitted to sell shares only with the agreement of the investor, and the other founders, whereby other shareholders have a right of first refusal to buy the shares. The price would be agreed upon between the shareholders for these cases, and that price would be lower than the valuation at the time of investment. As a matter of principle, agreements according to German Law restrict themselves to the relevant terms that the parties have agreed upon and include the modifications of the statutory law, if the applicable statutory law is disposable.

2. Bad Leaver Call Option

The definition of a bad leaver will always be linked to the employment contract or director-service contract of a manager or director with the company, unless the articles of the company and the shareholder agreement define a bad leaver situation separately. In Germany, agreements typically make references to statutory law in order to restrict the text of an agreement only to the mere minimum, instead of repeating the law which would not make sense.

The main reason for incentives to a founder or director or key employee of the company in the form of “sweet equity” is that the success of the company depends on the fact that the incentivised person will stay on and perform well in future. If that is no longer the case, either because of any wilful or negligent behaviour, or simply because that person loses his position as a representative of the company or even as an employee, that incentive can and must be withdrawn entirely.

Therefore, the reference to the statutory protection of employees against unfair dismissal and other statutory laws would apply as a priority to the contract in case of a conflict. While drafting of that clause the statutory law must be considered.

According to German Law, even a bad leaver cannot be dismissed without compensation for the shares that he loses (Sec. 738 par. 1 Civil Code – BGB). Therefore, the agreement must include a remuneration. That is mostly at nominal value, unless the true value is lower, or because the capital account is insufficiently

funded. The bad leaver loses all his shares, including the shares that are already vested.

Important to note is that an agreement that allows the majority of shareholders to dismiss a minority shareholder without cause is void (Sec. 138 Civil Code -BGB-).

In addition to that, the shareholder agreement to transfer the shares in a bad leaver case must follow the limits of Sec. 34 par. 1 GmbHG, which regulates that such case must be stated in the articles of association (Satzung) of the company.

Since the shares and names of a shareholder of a GmbH are registered on the trade register, the agreement stipulates that the bad leaver would have to transfer and sell his shares at nominal value to the company, whereby the other shareholders accept the transfer and purchase pro rata, unless agreed otherwise.

The agreement can best be enforced if the shareholder/director/employee signs the notary deed to assign and sell his shares under the circumstances of a bad leaver event, and to define such an event as best possible. If no such deed has been signed, the enforcement of the agreement is more than questionable.

In the case of the GmbH, it is possible to secure a contractually regulated call option or vesting regulation by means of a confiscation in the articles of association or alternatively to submit a debt collection in addition to a statutory collection procedure. A mere transfer claim in the sense of a call option is subject to a provision which already provides for a conditional offer to sell and assign the shares to the company or another shareholder. This provision does already have a material effect, so that, in addition to the condition, it only requires the unilateral (notarized) declaration of acceptance by the future acquirer.

In case of confiscation, the limits of the capital conservation protection (Sec. 34 III in conjunction with Sec. 30 I GmbHG) must be observed. With regard to the compensation payable, the confiscation order must not be in violation of Sec. 30 GmbHG. Therefore, the financial position of the Company should be reviewed before resolution and provision should be made in the Articles of Association for the payment of a severance payment to be due only if this is possible within the limits of Sections 34 III and 30 I GmbHG, i.e., the capital accounts of the company provide sufficient funds. The minimum capital of a GmbH for example is EUR 25,000. No payment must be made to a shareholder if that causes that amount to

be lower. In the case of a public shareholding company, that minimum capital amount is EUR 50,000, respectively (Sec. 7 AktG).

3. Good Leaver

A good leaver is every other than a bad leaver. He or she would have to transfer the shares that are not vested at market value to the company or individual shareholders, according to an individual agreement.

4. First Right of Refusal and Restriction to Sell Shares

Apart from a first right of refusal, the investor mostly reserves his right to 'Tag and Drag Along' in case of share sales. Unless the sale of shares to a competitor is entirely prohibited, in case a shareholder does it anyway, the investor is permitted to withdraw and sell all his shares as well.

5. Management Participation

Management participation raises a variety of legal and tax issues.

Company-law participations can be designed by providing different share classes, possibly in combination with shareholder loans, in the economic interest of the main shareholder. Subsequent capital gains should, with optimal structuring of the investment, qualify as capital gains and not as wages. The issue of options for the purchase of shares can only be made by the public shareholding company (AG) through a conditional capital increase. For a limited liability company (GmbH) options are subject to certain legal uncertainties, in particular with regard to the requirement of a notarial certification. In doubt, such agreements should be notarised in any event. Tax benefits are accounted for only after subscription of shares after exercise of the option.

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