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PRIVATE EQUITY INVESTMENTS IN GERMANY

HOW TO MANAGE HR RELATED RISKS
AND OPTIMIZE DEAL VALUE

PART I: EXECUTIVE COMPENSATION



A series of client briefings led by
our Employment & Benefits Group

EXECUTIVE COMPENSATION IN PRIVATE EQUITY INVESTMENTS IN GERMANY

PROFITS INTEREST STRUCTURES IN GERMAN COMPANIES

In US partnership structures, profits interests are a popular component of executive compensation packages because they tie value to the executive to a gain in the value of the company and offer tax advantages for the executive. Profits interest grants are particularly attractive because the executive does not need to invest money, and the executive receives the benefit of long-term capital gains treatment rather than ordinary income treatment.

This briefing deals with the alternatives available for competitive executive compensation packages in PE-owned German companies using instruments resembling the design of profits interest programs in the US. Bottom line: Although likely more complex, putting together compensation packages resembling US profits interests is legally possible in Germany.

GERMAN TAX ENVIRONMENT

When offering a compensation package to an executive in Germany it needs to be considered that, in respect of compensation programs, the German tax regime does not generally grant specific tax privileges that provide for capital gains treatment and, at the same time, for a tax deferral avoiding dry income. For instance, tax privileges for profits interests similar to the US rules are not available in Germany. In the absence of sufficiently relevant tax incentives for managers it is more challenging to put together a competitive compensation package.

However, if structured correctly, it is possible to achieve the aforementioned goals (no dry income, capital gains treatment) under the ordinary German tax rules. Broadly speaking, under such rules, a capital gains treatment (with an effective tax rate of less than 30% as opposed to a marginal tax rate for employment income in the amount of up to 45%) can be achieved if a manager makes an upfront investment and acquires an actual participation (in contrast to a mere bonus promise, phantom stock or similar contractual claim against the employer). In case of an upfront investment, dry income taxation can only be avoided if the manager pays an arm's length price for the participation.

In view of this environment the following options can be considered for ticking the boxes of an attractive executive participation offer—resembling a profits interest grant available in the US.

BALANCE OF INTERESTS IN EXECUTIVE COMPENSATION

Just as elsewhere in the world, PE funds investing in Germany typically strive to balance the need to attract top-level executives for their operating companies with the goals to “pay for performance” and to align the executives’ interest with the shareholders’ interest. Competitive executive compensation packages in German companies typically include (i) a base salary, (ii) an annual bonus and (iii) a participation in the appreciation in value of the company. From the executives’ perspective, the attractiveness of the compensation package offered correlates with whether and to what extent the grant of the management participation:

- avoids “dry/phantom income”, i.e. provides a tax deferral until such time as the actual value of the grant is realized,
- results in capital gains treatment on such amounts (rather than ordinary income tax rates), and
- does not require the executive to put significant own money at risk.



HURDLE SHARES

Management participations in the form of hurdle shares (also called growth or zero shares) in German corporations are trending. Hurdle shares are to be created as a separate share class with a negative liquidation preference entitling holders to benefit only if the value of a company at a future liquidity event exceeds the current value at the time of the investment. For instance, if a company has a value of 10 and hurdle shares with a negative liquidation preference of 10 are issued in addition to the existing ordinary shares, hypothetical future sales proceeds in the amount of 15 can be apportioned as follows: the first 10 will be for the benefit of the ordinary shareholders. The remaining five will be apportioned between the ordinary shareholders and the holders of the hurdle shares in accordance with the terms of an agreed “waterfall” mechanism.

As a result, the fair value of the hurdle shares at the time of the grant can be rather low because they are not yet “in the money” similar to an option not having reached its strike price yet. This allows a manager to invest a relatively small amount of money at arm’s length terms and, therefore, addresses the dry income issue. This especially applies to managers acquiring a participation subsequent to the date at which the original shareholders made their investment (i.e. on a date at which the value of the company has already increased). Moreover, if the management package is properly structured, a further appreciation in value of the hurdles shares should be taxable as capital gains income.

HURDLE SHARES

When implementing a hurdle share program, in particular, the following aspects need to be considered:

- A separate share class has to be created and it has to be decided whether the hurdle shares shall only have limited voting rights.
- If hurdle shares are issued in a close temporal connection to a third-party sale or a new financing round, it will be easier to determine an arm's length price for the hurdle shares.
- In the absence of price comparables, a robust company valuation might be needed to justify the price paid by the managers and to minimize the risk of alleged wage tax underwithholding. In such case, the valuation methods used by the valuator need to comply with German tax valuation principles (e.g. the exclusive use of a method for the valuation of options like the Black-Scholes model is unlikely to be accepted by a German tax auditor). In this connection, it must also be expected that the plausibility of the business plan agreed between the shareholders and the managers will be reviewed by the valuator.
- Special circumstances indicating that the primary reason for the issuance of hurdle shares to the managers is not their monetary investment but their employment have to be avoided because this could impact the capital gains treatment. In accordance with German case law, however, vesting and good/bad leaver provisions should be acceptable.
- It may be considered but can be difficult and time consuming to obtain a binding (wage) tax ruling for a hurdle share program.



Hurdle interests as a direct investment in commercial partnerships are not commonly offered in Germany because they usually result in unwanted tax consequences (like deriving partnership income).

PARTICIPATION RIGHTS AND SILENT PARTICIPATIONS

Contractual participation rights (Genussrechte) and silent participations are highly flexible instruments that can be used to incentivize executives by allowing them to participate in future profits of a company, both in partnership structures and corporations. Participation rights and silent participations are contractually agreed instruments that can be used to incentivize executives without granting them rights of a shareholder or partner. Due to their flexibility, participation rights and silent participations can be structured as equity or as debt instruments.

The tax treatment of interest grants in the form of participation rights or silent participations is subject to evolving case law, both on the level of the company and the executive. Careful consideration of the indications given by the German tax authorities and courts in connection with the grant rules may enable issuers to come up with competitive executive compensation packages.

Regarding the classification and tax treatment of participation rights at the issuer's level, recent guidance rendered by the German authorities provide for some clarity. However, the goal to treat the gain realized from participation rights and silent participations as capital gains can only be achieved if the evolving case law is properly reflected in the details of the participation program in terms of arm's length investment and profit share as well as the level of risk to be borne by the executive.



OTHER ISSUES TO BE CONSIDERED

The terms of the interest and equity awards given to the executives do not only matter taxwise, but need to address a couple of other issues as well. Common key points in Germany are set forth below.

In order to ensure the link between the employment of the executive with his/her participation in the company's value increases, award rules typically restrict the executive's right to transfer his participation rights until the respective exit date. If the executive's employment terminates prior to that date leaver clauses combined with vesting provisions and corresponding call options of the company kick in. Typically, award rules would also include drag along clauses for the event of an exit of the funds from the investment. The clauses governing the termination of employment or an exit scenario need to be drafted with due regard to pertinent case law in order to ensure their enforceability. In particular regarding bad leaver clauses, a balance needs to be struck because German courts may test these clauses with a view to the individual executive's right to terminate his/her employment.

Depending on the structure of the PE investment, regulatory rules regarding executive compensation or notification requirements under the German Anti-Money-Laundering rules might become relevant in setting-up the executive compensation program.

OPTIONS AND RSAs AND RSUs

In German corporations, equity grants to executives can also be done via stock-options (including ISOs), RSAs and RSUs. However, unlike hurdle shares, participation rights and silent participations, these alternative instruments are difficult to structure under German law in a way that they resemble the advantageous taxation of profits interest in the US.

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