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# PRIVATE EQUITY INVESTMENTS IN GERMANY

HOW TO MANAGE HR RELATED RISKS  
AND OPTIMIZE DEAL VALUE

**PART II: KEY ASPECTS FROM A HUMAN  
RESOURCES PERSPECTIVE**



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

PE transactions are special in many ways, including deal structuring and financing, tax-optimization as well as entrepreneurial and operational concepts post-closing. These peculiarities need to be reflected from the perspective of human resources in a PE deal.

This briefing deals with some of the specific aspects human resources functions need to be aware of in the context of PE investments in Germany in view of the intricacies of German employment, benefits and industrial relations laws. In particular:

- Employee reps might have a say already at the deal level
- Employment law aspects may bear a relevance for the planning of pre-closing steps in case of carve-out scenarios
- Retention of target's executive team needs to be ensured
- Consequences of post-closing reorganization plans need to be factored in at an early stage
- HR due diligence needs to focus on specific risks for the PE business model
- Investors' ESG parameters and regulatory constraints need to be factored in on the HR level
- HR needs to be aware of the specific challenges and opportunities in connection with a target in distress



## 1. EMPLOYEE REPS MIGHT HAVE A SAY ALREADY AT THE DEAL LEVEL

Employee representatives in Germany will likely need to be informed by the seller and/or the target about the envisaged acquisition by a PE fund. Investors should reckon with a certain level of skepticism of employee reps towards a buyout to private equity, because many of them might still have reservations against the PE-investment model. In the light of this environment it might well be likely that employee representatives could strive to establish impediments for the fund's value creation plans during or prior to the actual deal.

For German companies or groups with an attributable headcount of more than 500 employees a so-called co-determined supervisory board<sup>1</sup> must be established. Depending on the number of employee headcount attributable to the target, either one third or even half of the supervisory board members will be elected employee reps, very often union representatives. The role of the supervisory board basically is to control the

management of the target. Certain management decisions in connection with the seller's transaction plans may require supervisory board approval. Also on the business level, the works council and its economic committee have statutory information rights regarding a proposed change of control<sup>2</sup>. Special information/participation rights of employee reps apply should the target be a listed company. On that basis employee representatives can launch initiatives to establish restructuring roadblocks (such as job protections or site guarantees) via collective agreements already at the early stages of deliberations regarding a potential buyout in order to prevent suspected disadvantages for the target's employees under ownership of a PE investor.

In order to contain this risk, funds are well advised to develop a communication strategy addressing anticipated concerns of the target's employee reps, particularly in large-cap deals.

1. According to most recent available data substantially more than 2000 German corporations have a co-determined supervisory board.

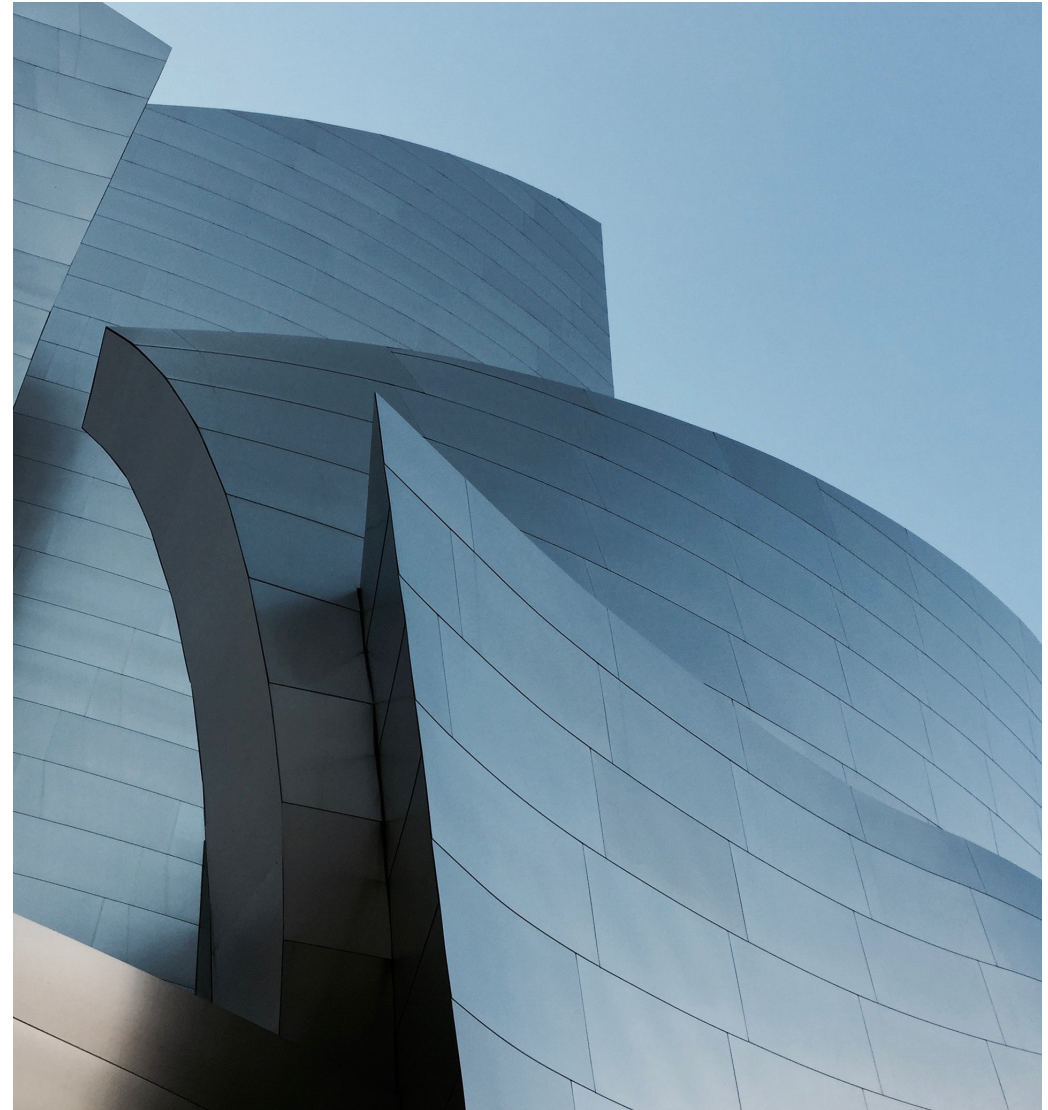
2. A works council can be elected in any German business site with 5 or more regular employees. According to most recent available data more than 40% of all employees in Germany are represented by works councils, albeit with significant deviations between industry sectors and geographies.

## 2. EMPLOYMENT LAW ASPECTS MAY BEAR A RELEVANCE FOR THE PLANNING OF PRE-CLOSING STEPS

The objective to run the target as a stand-alone business post-acquisition in a carve-out scenario often necessitates a range of pre-closing steps as part of the PE deal, such as the legal and operational de-integration of the target from the seller's incumbent organization or the securing of sufficient sourcing of the acquired business. The HR workstream needs to factor in the potential impact of German employment regulations on the fulfillment of closing conditions required for implementing the fund's desired post-closing business model.

Co-determination rights of the target's employee representatives may require time consuming and complex procedures, for instance in connection with a carve-out from the seller's incumbent organization, business split-ups or the creation of joint business sites. Furthermore, the German statutory rules on automatic transfer of employment contracts, particularly in connection with the sourcing of functions for the target's desired stand-alone business, may bear a risk for the projected personnel cost base and the post-closing business model.

The inherent employment law risks for envisaged pre-closing steps need to be analyzed carefully and should be properly managed in the transaction documents.





### 3. RETENTION OF TARGET'S EXECUTIVE TEAM NEEDS TO BE ENSURED

Typically, retaining the target's incumbent management team is an important objective of the PE fund.

A priority for accomplishing this objective is to offer an attractive compensation package to the target's management team<sup>3</sup> while ensuring alignment of the executives' interest with the fund's interest of unlocking the growth potential of the target and to "pay for performance". In Germany, competitive executive compensation packages typically include an incentive component based on 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: (i) avoids "dry/phantom income", i.e. provides a tax deferral until such time as the actual value of the grant is realized, (ii) results in capital gains treatment on such amounts (rather than ordinary income tax rates), and (iii) does not require the executive to put significant own money at risk. Although 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 (like, for instance, tax privileges available for profits interest in the US), compensation packages that meet these criteria can be structured should the management participation be granted in the German target directly, rather than through a management participation entity outside of Germany. The actual terms of the interest and equity awards given to the executives (such as leaver clauses, vesting provisions or call options) need to be drafted carefully with due regard to their potential tax impact and enforceability requirements under German law.

In order to ensure the retention of the incumbent management team one key focus of the HR due diligence should be on the target's and/or the seller's contractual arrangements with the individual executives, in particular on change-of-control clauses or contractual severance packages. Based on this analysis retention commitments, including consultancy arrangements, pre-closing should be considered. Finally, the retention of the incumbent executive team should be reflected in the transaction documents.

3. For details please check out the client briefing of the Mayer Brown Employment & Benefits Group on Private Equity Investments in Germany, Part I (Executive Compensation), available for download: [pe-in-germany.pdf \(mayerbrown.com\)](#)



#### 4. "RESPICE FINEM" - CONSEQUENCES OF POST-CLOSING REORGANIZATION PLANS NEED TO BE FACTORED IN AT AN EARLY STAGE

The implementation of plans contemplated by PE funds for reasons of tax-optimization (such as a debt push-down) or the enhancement of the target's value (such as reorganizations) might bear the risk of unwanted consequences under German employment law. Amongst the most common pitfalls in connection with reorganization measures (such as up- or downstream mergers and carve-outs), or the conclusion of inter-group agreements (such as profit and loss pooling or domination agreements), are the following:

Implementation of these measures may result in a multiplication of employee co-determination on the target-group's supervisory boards, because of changes to the employee headcount attributed to individual target group entities<sup>4</sup>. If the target or the target-group runs a business not only in Germany, but in another member state of the European Union or the European Economic Area, reorganizations or restructurings may

also have an impact on the structure and composition of employee representation bodies on an international level through a European Works Council or its equivalent. Furthermore, there is a potential risk that collective agreements containing roadblocks for post-closing personnel measures, including downsizings (such as job guarantees or site protections) will be triggered. Concluding inter-group agreements might create the legal ground for increased post-closing restructuring costs, because shareholders' pockets might become liable for subsidiaries' social plan funding. Finally, German employment regulations could result in an allocation of personnel and pension liabilities<sup>5</sup> that may have a negative impact on the target's cash flow and balance sheet.

The HR workstream will need to anticipate these consequences and, thereby, contribute to a sophisticated post-closing concept as part of the PE deal.

4. See page 2 (1. Employee reps might have a say already at the deal level).

5. Details on the issues in connection with pension and HR liabilities and their management will be dealt with separately in Part III of the Mayer Brown Employment & Benefits Group's client briefing series on Private Equity Investments in Germany; stay tuned!

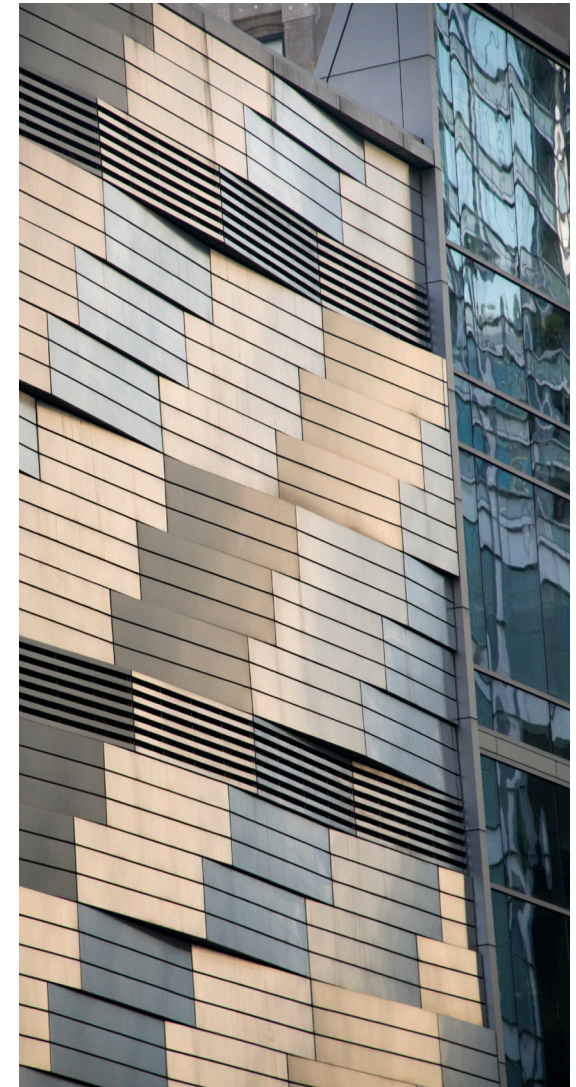
## 5. LEGAL HR DUE DILIGENCE NEEDS TO PUT SPECIAL FOCUS ON SPECIFIC RISKS FOR THE PE BUSINESS MODEL

Obviously, the legal due diligence of the target needs to specifically focus on personnel related issues and risks which may have a particular bearing for the PE business model. Under German employment regulations the target's set up could contain roadblocks for the implementation of the fund's value creation plans and/or could have a negative impact on the cash flow of the target, its ability to carry debt as well as on the fund's exit planning. In particular due diligence needs to focus on identifying the following issues:

- Impediments for post-closing restructuring: collective agreements (such as works council agreements and collective bargaining agreements entered into with the unions) can restrain the options for implementing the PE fund's plans to unlock the target's growth potential or to improve the target's business and enhance value during the investment cycle. Amongst the items to watch out for are binding commitments regarding job protections, site guarantees or approval requirements for personnel measures, including downsizings, or business reorganizations.

- Obligations or "hidden" liabilities that may have a negative impact on the target's cash-flow (such as investment commitments towards the unions, pending employment litigation or certain obligations in connection with government subsidies granted to the target) or its balance sheet (such as unfunded pension or personnel liabilities).
- Target's and/or the seller's contractual arrangements with individual executives, in particular on change-of-control clauses, severance packages or non-compete covenants.
- Special packages and liabilities vis-a-vis employees who have joined the target through historic transfers of employment on the basis of the German statutory rules on automatic transfer of employment contracts.

These issues need to be identified during the due diligence process and, if possible, properly managed in the transaction documents. In order to limit the allocation of personnel liabilities to the acquired target structuring the acquisition as a (partial) asset purchase, instead of a share deal, should at least be considered.



## 6. INVESTORS' ESG PARAMETERS AND REGULATORY CONSTRAINTS NEED TO BE FACTORED IN ON THE HR SIDE

The fund's investors (such as pension funds) may be obliged to comply with certain criteria regarding their investments (such as meeting ESG scores in their investment portfolio). The challenge for the PE fund typically is to translate these investment restrictions into the relevance of the HR set-up of the target and adapt the focus of the HR due diligence accordingly.

To the extent ESG factors form part of the investor's regulatory metrics, the HR due diligence should particularly focus on the target's sustainability reports. German companies are subject to the EU regulations on non-financial reporting. From an HR perspective an increasing focus is on the existing and upcoming reporting standards on items such as human rights, diversity & inclusion, workplace safety and industrial relations. Hence, the PE funds should expect the target to provide sufficient data on social and governance factors (alongside environmental sustainability factors) based on the target's non-financial reports.

Obviously, proper safeguards need to be contained in the deal documents.

## 7. HR NEEDS TO BE AWARE OF THE SPECIFIC FEATURES REGARDING A TARGET IN DISTRESS

Particular challenges and opportunities may arise, if the PE fund contemplates a buyout of a German target in distress. German employment law provides for a range of special rules applicable to employment relationships and the allocation of personnel liabilities in an insolvency scenario. These will need to be taken into account in the conceptualization of a distressed PE deal and the fund's value creation plans.

Under German insolvency law the personnel related liabilities (such as pension liabilities or the employees' contractual entitlements) to be assumed by a buyer of a German target's assets are substantially limited. Provided an asset purchase makes sense in view of the value distribution structure of the PE fund, these limitations on liability allocation to the buyer in a reorganizational business transfer (*sanierende Übertragung*) may increase the attractiveness of an investment in distressed assets.

Timing matters, as the liability limitations will, in principle, only be available after the formal opening of the insolvency proceedings. Certain exceptions apply to the liability limitations (such as for liabilities accrued for delinquent salary claims or old-age part-time commitments), which will typically need to be reflected in the purchase price mechanism. Implementation of the buyer's restructuring concept by the seller (the insolvency administrator or the target's management in specially regulated proceedings) pre-closing will be possible with significant statutory alleviations on employee co-determination procedures.



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