ORRICK LEGALNINJA SERIES

8

ESOPs, VSOPs & Co.

STRUCTURING / IMPLEMENTATION / BEST PRACTICES

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orrick

VC & TECH BRIEFINGS GERMANY

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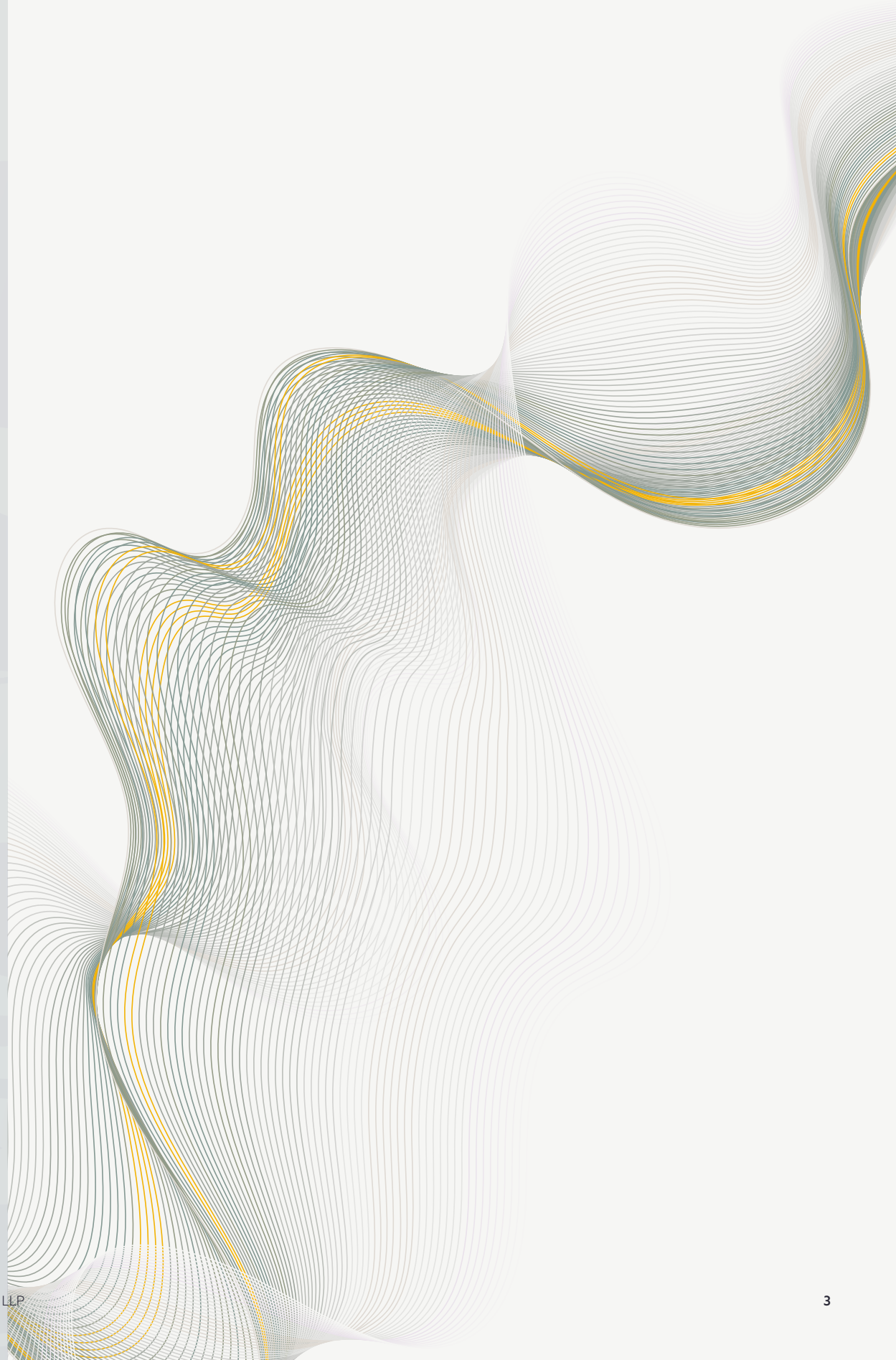

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ORRICK LEGALNINJA SERIES

About the Orrick Legal Ninja Series – OLNS

The Orrick Legal Ninja Series ("OLNS") is Orrick's flagship content platform for the German entrepreneurship ecosystem. As a global law firm with deep roots in the world's leading technology markets, we are passionate about supporting German founders and investors—not just with legal advice, but with holistic, actionable insights that help shape the long-term success of their ventures.

What sets OLNS apart? We go beyond the legal fine print. Our series explores the intersections of law, business, and innovation, drawing on lessons learned from national and international tech hubs. We believe that the best advice for entrepreneurs and investors is grounded in a broad understanding of how legal frameworks, market trends, psychology and company-building strategies interact over time.

OLNS is co-authored by a multidisciplinary team of lawyers and business professionals from our German and international offices. Together, we tap into Orrick's global reservoir of venture capital, corporate innovation, and technology know-how to deliver content that is relevant, practical, and forward-looking for the German innovation scene.

Why "Ninja"?

Let's be honest—some of us did watch a few too many action movies in the 1990s. But more importantly, "Ninja" has become shorthand for someone who combines skill, agility, and relentless curiosity to master their craft. That's the spirit we bring to our work with tech companies and investors, and it's the mindset we hope to inspire in our readers: to become "legal ninjas" in navigating the challenges and opportunities of entrepreneurship.

We invite you to join the conversation. Whether you're a founder, investor, or ecosystem builder, we'd love to hear your experiences and perspectives. OLNS is a living project—constantly evolving as the tech landscape changes and as we learn from you.

Thank you for reading this revised and expanded edition of OLNS#8. We hope it empowers you on your journey.

On behalf of the Orrick Team,

Sven Greulich
Orrick – Technology Companies Group Germany

A. Employee Ownership for German Start-ups

I. Preface

Employee ownership (sometimes also called "employee participation") plays a critical role in attracting and retaining top talent for fledgling young companies and aspiring growth companies alike. Stock options and similar structures, reward employees for taking the risk of joining a company in a high-risk and rapidly evolving environment and give them a stake in their company's future success. For start-ups, giving "equity" is one of the main levers to recruit the top talent they need—because let's face it, they can't compete with the salaries or job security that more established players provide.

But here's the key: employee equity isn't just about getting people in the door—it's about keeping them inspired and committed for the long haul. Allow one of the more seasoned authors among us to make a metaphor: Employee ownership is like a marriage. Granting stock options is the fun and easy part—like getting married. But designing and implementing a scheme that keeps your best people engaged year after year (*i.e.*, staying married, or even better: staying happily married)—that's where the real work (and reward) lies. In today's hyper-competitive start-up and tech landscape—especially in fields like AI and deep tech—retaining top talent can sometimes be an Olympic-level challenge.

"You can't build a great company without great people – and you can't keep great people without giving them a stake in the outcome."

Fred Wilson, Partner at Union Square Ventures

While employee ownership programs have been around for quite some time, the ground is shifting for them and their design and implementation requires constant monitoring and, where necessary, adjustment. One example that we will explore later in this Guide is that the road to exits or initial public offerings ("IPO(s)") is getting longer, while employee tenure is getting shorter. Start-ups now need to evolve employee ownership programs from being mere hiring perks to becoming essential strategies for building lasting loyalty and commitment (see Chapter A.II.2.).

In the past, the United States has long been the global trailblazer for employee equity. Decades of experience have shaped a culture where employee ownership is not just a perk but a core part of the start-up DNA. U.S. companies have developed sophisticated, tax-efficient plans that are both attractive and practical. Let us just pick out one key lesson to illustrate the point. As we'll discuss in more detail in Chapter A.IV.3., U.S. practice has always taken a more pragmatic—and arguably smarter—approach to leavers, *i.e.*, employees who leave the start-up before the expiration of their vesting period. So-called "voluntary leavers"—*i.e.*, employees who resign during the vesting period without good reason—are generally treated as good leavers, *i.e.*, they can keep the vested part of their allocation assuming they leave after the expiration of the cliff period of usually 12 months. In the past, German programs often foresaw for such voluntary leavers at least a partial or even complete forfeiture of the vested part while U.S. schemes have always focused less on punishment and more on rewarding those who stay. Their focus is on retention, not retribution. Quick side note: With a recent landmark decision, the German Federal Labor Court (*Bundesarbeitsgericht*-"**BAG**") now *de facto* forces German start-ups to follow the U.S. approach which in turn requires German start-ups to develop a more strategic approach to the implementation of a (hopefully) well-designed program.

Of course, legal and regulatory frameworks differ widely. The U.S. system is built on a relatively flexible corporate law environment and a tax code that, while complex, has long recognized the value of employee equity. In contrast, Europe has faced a patchwork of outdated, inconsistent, and sometimes downright punitive rules. But the winds are changing across Europe, and particularly in Germany, where founders and investors now have new tools at their disposal and a mindset that increasingly values employee equity as a strategic asset. The gap is closing, both in terms of regulation and entrepreneurial culture (come to think of it, we don't think that we as lawyers ever felt that level of optimism...).

THE GERMAN WAY OF SHARING

German start-ups are finally catching on to what Silicon Valley figured out decades ago: sharing the wealth keeps talent from walking out the door. The latest numbers from the Bitkom Report 2025 reveal a pragmatic but encouraging shift and continue trendlines we observed over the last years.

Important note: Below we will summarize the main findings of Bitkom's survey. However, when interpreting these figures, it is important to note that they are based on a sample of just 152 tech start-ups and also includes start-ups that have not received venture funding. We at Orrick believe that for venture capital-backed start-ups the numbers will be significantly higher.

- Four out of ten German tech start-ups (40%) now offer some form of employee participation, while nearly half (47%) are warming up to the idea for the future. Only a stubborn 8% refuse to share the pie entirely—a refreshingly small minority in today's talent-hungry market.
- When German start-ups do decide to open their equity vault, they take a characteristically measured approach. Virtual shares dominate the landscape at 28%, followed by traditional stock options at 9%, and real equity stakes at just 8%.
- The hierarchy remains distinctly German too. A third (33%) keeps participation exclusive to the C-suite, while 41% extend invitations to selected employees beyond management. Only 23% embrace the radical notion of offering participation to everyone.

For German start-ups competing against established corporations and international players with deeper pockets, employee participation has become less luxury and more necessity. To say it in the words of one observer: "If you can't match the salaries, at least give them a reason to believe in the vision".

And yet, while many founders instinctively understand that giving employees a slice of the pie is important, they often struggle to identify the best approach for their specific situation. With this Guide, we want to help founders, and their investors, better understand what employee ownership is, why it matters, and how to implement it effectively. Drawing on our experience with thousands of start-ups worldwide and dozens of founders and investors we interviewed for this Guide, we'll offer practical guidance on challenges German start-ups face—like using employee ownership programs for international hires, accounting headaches, and what to keep in mind when these programs intersect with financing rounds or M&A transactions. From the basic building blocks of equity-based and virtual programs, through the all-important questions of smart implementation, tax treatment, and governance, to the real-world impact on company culture and exit outcomes, we'll lay the foundation for navigating the equity maze. Along the way, we'll challenge some myths, share lessons learned from the trenches, and set the stage for the deep dives and practical guidance that follow in the rest of this Guide.

And as a bonus, if you keep reading, you'll find not only (as in every edition of the OLNS) a quote from one of our co-author's favorite writers, *Mark Twain*, buried somewhere in the pages to come, but also another from *Kermit the Frog*. Because, as every founder knows, sometimes it really isn't easy being green.

> "Please don't do anything stupid or kill yourself, it would make us both quite unhappy. Consult a doctor, lawyer and common-sense specialist before doing anything in this book."
>
> *Tim Ferriss*, Tools of Titans

II. The Rationale for Employee Ownership and its Challenges

Employee Ownership (we will define that term in a second) is far more than a technical footnote in the German start-up playbook—it's the unsung hero behind every story of bold hiring, relentless ambition, and breakthrough innovation.

This introductory Chapter pulls back the curtain on what "Employee Ownership" really means with a focus on the German market. Ready to find out how ownership can transform not just your cap table, but your company's destiny? Let's get started.

"Culture eats strategy for breakfast, but equity eats culture for lunch."

VC saying or maybe just what AI attributes to some VC investors, but true nevertheless

1. "EMPLOYEE OWNERSHIP" AND THE FOCUS OF THIS GUIDE

Before we present the various employment participation structures that are available to German start-ups and explain how these programs can be implemented, let us lay some groundwork and agree on some mutual terminology to avoid unnecessary confusion. (No worries—the tax and corporate details of the plans will be complicated enough, we promise.)

Employee Ownership: When used in this Guide, "**Employee Ownership**" refers to the various tools a company has at its disposal to give its employees an incentive to join the company, stay with the company for a certain period of time, work diligently and hard and participate in an increased and ultimately realized value of that company. As we will see shortly, Employee Ownership can come in a variety of forms,

- ranging from a direct shareholding in the company or options to purchase a certain number of shares in the company at some point in the future (*i.e.*, "real" equity);
- through equity-like instruments such as profit participation rights (*Genussrechte*—"**PPR**");
- to a mere virtual participation that gives the employee a certain cash payment amount upon the occurrence of certain events, usually referred to as *exit* or *liquidity* events. The latter group is sometimes also referred to as "phantom equity".

Although it is not unambiguous either, we use the term "Employee Ownership" rather than "employee participation," as the latter term is also often used to describe a participative approach to management to foster the mental and emotional involvement of employees by giving them a say in decision-making processes on all levels.

Focus on GmbH and UG but Also Discussing the Inc.: In this Guide, we focus on privately held German start-ups that are organized as either a GmbH or an UG (*haftungsbeschränkt*) (by far the dominant legal forms in Germany) and the employee incentive schemes that they typically implement. Once your company has changed its form to a stock corporation (*Aktiengesellschaft*) or European stock corporation (*Societas Europaea*) and in particular once its shares are listed on a stock exchange, companies have other tools available to set up long-term incentive schemes that we cannot comprehensively cover in this Guide. However, in this updated edition of OLNS#8, we added a discussion of U.S.-style plans that are now available in a pretty tax-efficient way to the employees of a German GmbH that has been flipped into or set up from scratch as a U.S./German two-tier structure with a U.S. corporation (usually a Delaware C-Corp) sitting on top of an operational German entity (see Chapter A.V.3.2.).

Focus on Exit-driven Programs: In addition, the incentive scheme structures presented in this Guide are usually "exit-driven". What do we mean by that? As "exit-driven" we describe a program where the economic rewards for employees—whether through virtual shares, stock options, or (other) equity grants—are typically tied to a liquidity event. In most German and international start-ups, this liquidity event is either a sale of the company (via a share deal or asset deal) or an IPO. In other words, employees "cash in" when the founders and investors do, aligning everyone's interests toward building a company that's attractive to acquirers or the public markets. This model makes perfect sense for venture-backed companies, where the roadmap almost always leads to an exit (well, in most cases it leads to liquidation, insolvency or a distressed exit, but who would call the lawyers pessimistic...). But what if your company's journey looks different? Not every founder wants to bring on outside investors or sell the business in the medium term. While not the focus of this Guide, we will also discuss some alternative incentive structures for start-ups that are not exit-driven (see Chapter A.II.5).

The Terminology Used in This Guide: Talking about Employee Ownership programs can be confusing at times (not to mention getting the numbers right...). There is a lot of financial jargon and VC lingo that can make ploughing through the mechanics as well as commercial and tax issues of a program even harder. In the German market, things are further complicated by the fact that, as is so often the case in VC land, we try to replicate and emulate what has been developed in the United States—where Employee Ownership in start-ups is a standard feature and well-established documentation, and commercial benchmarks exist. In Germany, our corporate and tax laws don't allow for a simple adoption of what has been tried and tested elsewhere. Keep in mind that in Germany, for reasons we will discuss shortly, German start-ups (still) use both virtual and equity-based programs that are in practice often simply referred to as "*employee stock option programs*" or "*ESOPs*", although they have a different structure and logic.

So, let's make our life a bit easier and agree on some basic terminology we will use throughout this Guide. We will add some terms in the further course of our discussion and have compiled a list of the most important terms and their meaning in a **brief glossary** at the end of this Guide (see Chapter D.).

- **ESOP:** We will use this term for equity-based programs, *i.e.*, programs that grant employees "real shares", options to acquire real shares as well as PPR. The latter is an "equity-like" instrument that recently attracted some attention as it seeks to achieve the tax-favorable status under sec. 19a German Income Tax Act (*Einkommensteuergesetz*—"**EStG**") while avoiding the corporate governance issues that come with the grant of actual shares.
- **VSOP:** We will use this term for virtual programs, *i.e.*, programs that economically seek to simulate an ESOP without issuing real shares or options for real shares.
- **Employee Ownership:** We will use this term as an umbrella for the various forms of allowing employees to participate in the equity upside of their employer start-up, usually in the form of an ESOP or a VSOP.
- **Awards:** For ease of reference, we will apply this term to all kinds of (real or virtual) options or shares and equity-like instruments issued under an ESOP or a VSOP. Just keep in mind that, for example, in case of a VSOP, a virtual option or virtual share does not actually give its holder a right to acquire real shares and a PPR might be an equity-like instrument but isn't a real share either.

But Beware: In the international context, the terms used in Germany tend to cause confusion. For example, in the United States, VSOPs are rare and references to "ESOPs" usually include real option programs as well as restricted stock grants, while the concept of a PPR is in our experience almost unknown and requires a lot of explanation. In the international context, and especially when issuing Awards under an ESOP to international beneficiaries, particular attention must be paid to this matter, as misunderstandings can easily arise.

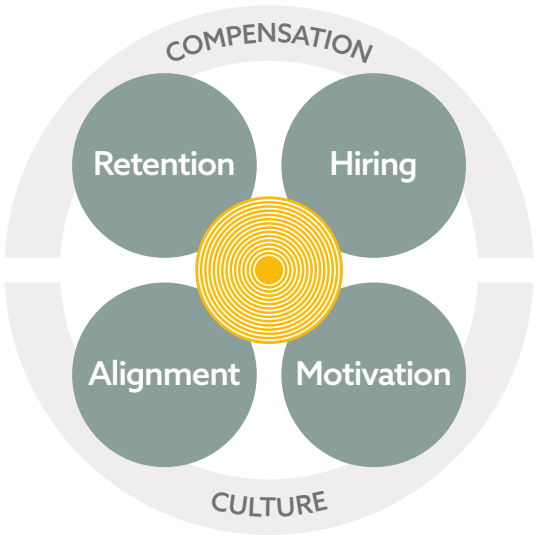
2. WHY IS EMPLOYEE OWNERSHIP SO IMPORTANT FOR START-UPS?

Employee Ownership is not only a tool for compensation but also pivotal in aligning employee interests with company success, particularly in scenarios where rapid technological advancements necessitate attracting and retaining top-tier talent. The ability to offer compelling equity packages can differentiate companies in attracting and retaining the best minds.

As mentioned above, Employee Ownership is more than just wooing potential employees and Employee Ownership programs need to go beyond the "first minutes". To provide some structure and goal posts, when designing and evaluating Employee Ownership approaches, we distinguish the following four categories and goals:

- hiring;
- retention and rewarding;
- alignment; and finally
- motivation and incentives.

The first two categories relate to **compensation**, while the latter two pay onto a company's **culture**.



Obviously, the categories overlap, influence and reinforce each other. Nevertheless, we find this distinction helpful to set the framework for any Employee Ownership scheme. Throughout this Guide, we will come back to these main motivational drivers and explain how special plan features and implementation strategies can support or undermine them.

Given the importance of Employee Ownership for the success of a start-up, it is of great importance that a well thought-out and functioning Employee Ownership plan is implemented from the very beginning. Of course, over time, the program will have to be adapted to the circumstances or, if necessary, supplemented or replaced by a new program. All too often, however, one sees that especially in the early stages of start-ups, agreements are made—or better: promises are made—that are not thought through and provide only flawed incentives at best. Such deficits can only be addressed with difficulty at a later stage—especially when the valuation of the start-up has risen.

2.1 Hiring

In today's supercompetitive employee markets, the challenge for the start-up newcomers can be daunting. What is on offer for employees at Big Tech—we mean other than the obvious answers of high cash salaries and generous retirement schemes? Well, there is quite a rich and expending range of employee perks offered in particular by successful U.S. tech companies but also some of the well-funded European scale-ups.

Let's digress for a moment. You are looking for some current inspirations from international start-ups to make their employees "feel it"? Hold my cup of matcha chai latte:

- How about offering your employees professional house cleaning services paid by the company?
- Too practical and not creative enough? No problem—how about "pawternity" leave? One of our authors became an even bigger fan of his favorite Scottish brewery, *Brewdog*, after discovering they offer employees paid time off when they adopt a dog, just to help the new furry family member settle in.
- Again, more on the practical side are offers from some American start-ups for free full-body MRI scans for employees and family members.
- Coming back to the topic of this Guide, a last example is from *Netflix*, where certain groups of employees can personally decide on how to mix their pay package, *i.e.*, allocate their given compensation freely between cash and (vested) stock options.

The offerings have become so plentiful that they sometimes make it difficult for employees to compare different job offers. But one person's problem is a VC's investment opportunity. Enter total reward platforms that give employees a transparent dashboard of everything they're getting.

But let's get back to the financial side and the role that Awards play.

While the (financial) motivation for the founder team with its significant stakes in the start-up's common shares and its hopes of ending up one day on the *Forbes* list seems clear, other "regular" employees might wonder why on earth they should join a fledgling wannabe with often little more than a vague product idea. (We don't even dare to mention business model here.)

"After all, European technology companies are finally attractive for American investors. Now comes the next challenge: We need to get the best talent to Germany. To do this, employee ownership in Germany must be made more attractive. We are in global competition. And that competition will be decided by our employees. Money alone won't help."

Christian Hecker, Co-Founder of Trade Republic—note: convenience translation by the authors

Of course, a compelling mission and great firm culture are the bedrock for any successful talent strategy, but there is another card that start-ups can play. Many investors and founders alike seek to adapt and apply best practices from Silicon Valley to their European start-ups, and they consider Employee Ownership to be one of the key ingredients to the success of the Bay Area tech companies. There, employee grants have helped attract some of the world's best talent to small unknown upshots with limited cash, but near limitless potential.

Obviously, it depends on the business sector of the start-up, but for most tech-focused start-ups, the relevant talent often comes at a (lawyers' humor ahead) "strike price" premium. If your focus is on leading-edge technical challenges, you'll need a substantive and exceptional technical team. Competition for such talent is fierce, and so these hires will expect bigger Award packages.

"As the ecosystem matures, employees get more sophisticated and are more willing to trade-off salary for options."

Martin Mignot, Partner at Index Ventures

While believing in the start-up's mission and the founders' vision can make for great blog posts later on—when, on the occasion of a successful IPO or acquisition, employee #4 reflects on what, at the time she joined, was little more than a vague idea dreamed up by some mid-twenties in a garage or incubator space—the less glamorous and more cold-hearted answer to why employees should consider joining early on is "equity upside". So, here we go: Back in 1999, Bonnie Brown answered an ad for an in-house masseuse at *Google*—then a small Silicon Valley start-up with just 40 employees. (And yes, we know what you're thinking: why was my firm's 41st hire that in-house legal counsel?) Bonnie got the job—and a lucky break. Her part-time role paid USD 450 a week, plus a handful of *Google* stock options that she assumed would never be worth anything. Well, they turned out to be worth quite a bit more. As *The New York Times* reported in 2007: "After five years of kneading engineers' backs, Ms. Brown retired, cashing in most of her stock options, which were worth millions of dollars. To her delight, the shares she held onto have continued to balloon in value".

Here are a few more recent examples from the world of Big Tech. On September 11, 2025, *Fortune* titled "*Klarna*'s $17 billion IPO has just turned 40 staffers into overnight millionaires—while Nvidia, Canva, and Palantir workers are seeing similar gains". *Canva* has also created new millionaires after the tech company launched an employee share sale in August 2025, which valued the business at $42 billion. *Cliff Obrecht*, Canva's chief operating officer, said in an email to staffers that current and former staffers who are eligible would be able to sell up to $3 million worth of shares.

While we will discuss grant benchmarks and individual allocations in more detail later in this Guide (see Chapters A.V.1. and A.V.2.), suffice it to say that in the U.S., the earliest few key hires might expect a few percentage points of the company's total equity. While expectations used to be somewhat lower in Europe, they have adjusted upwards over the last years in sync with the ever-increasing sophistication of the entrepreneurship ecosystems in the Old World.

2.2 Retention and Rewarding

Hiring top talent is only the first step; retaining it is where the real challenge lies. In this context, Awards that vest over several years and allow beneficiaries to participate in the (hopefully) ever-increasing valuation of their employer play a pivotal role. For instance, when *Auto1* went public in 2021, its IPO prospectus revealed that, assuming an offer price at the mid-point of its range (the company ultimately priced at the higher end), the aggregate value of claims under its early-stage VSOP would amount to approximately EUR 132.1 million upon completion of the IPO. This underscores the long-term value that well-structured employee participation programs can deliver.

Features such as cliff periods, thoughtful vesting schemes—which might include also back-loaded vesting, where the bulk of Awards vest only in the latter part of the vesting period—and systematic and well-structured refresher or top-up grants serve to emphasize the retention element. These mechanisms create economic disincentives for employees to leave prematurely and help align long-term interests.

Rethinking Plan Designs – Two Shifting Time Horizons: The classic four-year linear vesting schedule has long been the gold standard for employee ownership programs. However, the start-up landscape is evolving rapidly. Two major time horizon trends are reshaping the way employee equity should be structured: Start-ups are taking longer to exit, but employees are moving on more quickly. This means that founders and investors must rethink the "set it and forget it" approach to Employee Ownership. Awards should be treated as a living, strategic tool—one that adapts as the company and its team evolve. Let us look at both trends in a bit more detail. We will revisit their implications when discussing plan design elements and smart implementation strategies in the remainder of this Guide.

Longer Exit Horizons: These days, start-ups are remaining private for longer periods. The era of quick exits or IPOs within a few years of founding is largely over. According to *PitchBook*, the median age of U.S. venture-backed companies at exit reached 8.2 years in 2023, up from 4.9 years in 2013. The latest exit data puts this in sharp perspective: After a record "exit boom" in 2021, VC exit-activity in the U.S. dropped off a cliff, hitting post-pandemic lows in 2023. While 2024 brought a modest recovery, the total number of exits is still well below the long-term trend line. For founders and employees, this means the window for a traditional exit or liquidity event has narrowed and the wait for a real payout is longer than ever.

In Europe, *Dealroom* data shows the average time to exit for tech companies is now 7-8 years, and for deep tech, often even longer. German start-ups, in particular, are often maturing more slowly, with many taking a decade or more to achieve an IPO or exit.

As a result, Employee Ownership programs need to be robust enough to support a multi-year, sometimes decade-long, growth journey. This entails for example:

- transparent and consistent grant and pricing principles that can be communicated and applied over several funding rounds;
- vesting schemes that remain fair and motivating as the company's valuation and team composition evolve; and
- a clear plan for top-up or refresher grants, ensuring that early joiners do not find themselves fully vested years before an exit.

Shorter Employee Horizons: While companies are taking longer to exit, the employee's tour of duty is not keeping up and show quite a lot of fluctuation. According to U.S. market data from March 2025, 47% of all active start-up employees have three years or more of tenure (that number has most recently showed some upward trend after it came down during the COVID-19 period and its immediate aftermath). Still, high turnover in the early years is real – 15% of employees are in their first year, 14% stay one to two years, and 24% are around for two to three years.

Put differently: nearly half the workforce at high-growth start-ups remains with the company well beyond the three-year mark. This calls for equity plans that address both early volatility and longer-term retention, ensuring the strategy motivates newcomers and continues to reward loyal contributors.

While European and German data is less granular, recruiter surveys (*StepStone*, *LinkedIn*) suggest similar, if slightly less pronounced, trends: average tenure at high-growth German start-ups is now estimated at around 2-3 years, down from 3-4 years a decade ago. The pandemic, the normalization of remote work, and a highly competitive talent market have all contributed to higher churn in recent years, but it remains to be seen if the current macroeconomic instabilities and challenging markets might slow down or even partly reverse that trend (in some sectors and cities we already see rising tenure periods again).

Consequently, traditional four-year vesting schedules with a one-year cliff may no longer align with the reality of today's workforce. If most employees leave before they are fully vested, the Employee Ownership program can lose its intended motivational power and may even create frustration among those who feel they contributed to the company's growth but left with little or nothing.

It is therefore essential that Award grants are not treated as one-off hiring incentives. Instead, equity must be viewed as an integral part of a long-term remuneration package, with clear communication about how it fits into total rewards and career progression.

Designing for Retention and Alignment: Employee Ownership plans need to be designed to reward not just for joining, but sustained contribution over time. This requires a strategic approach to vesting, refresher grants, and the overall employee journey, including the following elements:

- Equity should be kept "fresh". For key employees, more frequent refresher grants may be advisable to maintain a meaningful unvested equity position. This aligns incentives for long-term retention and ensures that early joiners remain engaged. In addition, top-up grants can be performance- and role-dependent, not automatic, to avoid entitlement issues. We will discuss the various top-up and refresher grant options (no pun intended...) later in more detail (see Chapter A.V.2.2.).
- Vesting schemes may need to be rethought. Back-loaded vesting, where the largest portion of Awards accrues in the latter part of the vesting period, can further strengthen retention. Such schemes can be combined with longer vesting periods and potentially larger initial allocations or more frequent grants. Again, more of this to come (see Chapter A.IV.3.).

2.3 Alignment

Another argument that is often brought forward for Employee Ownership is that it would align with the interests of the shareholders and the start-up's employees—increasing the value of the company—and help overcome silos, inertia, and obstacles to collaboration within the start-up's organization.

While this reasoning sounds plausible, we note that incentive alignment is a complex matter. We will limit ourselves to a few remarks:

Employee Ownership programs in the form of ESOPs and VSOPs will generally only result in pay days for the beneficiaries upon the occurrence of an exit or liquidity event although some programs feature early settlement options for the company in certain leaver cases. Keep in mind, further, that Awards in German start-ups usually do not allow their holders to participate in dividends. (We know... not a likely scenario in a start-up.) Hence, Awards will have their beneficiaries focus on an exit or liquidity event, *i.e.*, usually a sale of the company or an IPO. Awards are less about the long-term health of the company but rather a part of the founders' and investors' exit plan. It remains to be seen if the classical Employee Ownership programs with their four-year vesting and exercise only upon exit or liquidity event will need to evolve against some trends in VC financings and exit patterns that became obvious over the last couple of years.

As we have seen above, the time to exit has grown significantly over the recent history, and we do not expect this trend to reverse any time soon. Some start-ups have in recent years deviated from the four-year vesting towards longer vesting periods.

As mentioned above, these longer time horizons can dilute the effects of an Employee Ownership program on employees' morale, motivation and alignment. A fact that can be further aggravated when founders and early backers (usually the business angels) decide at some point to cash in a portion of their stakes through so-called *secondary share sales* as part of just another financing round.

Nonetheless, some German tech companies have recognized this potential misalignment and, from time to time, voluntarily offer their employees early opportunities to take some money off the table. Recent examples include the HR-tech unicorn *Personio* and the scale-up *TaxFix*. When *TaxFix* closed a USD 65 million financing round in early 2020, a group of eligible current and former employees were offered the chance to sell a portion of their vested Awards (*TaxFix* had implemented a VSOP). According to the company, it paid a total of EUR 3.8 million as part of this early exercise opportunity to reward past performance and show that the virtual assets the beneficiaries held were of real value. Such a "buyback" can be advantageous for the start-up's shareholders, as the corresponding Awards then flow back into the Employee Participation pool and no increase, or only a correspondingly smaller increase, will be demanded from new investors in later financing rounds.

> "In successful scale-ups, a partial exercise of vested options prior to exit can be a powerful reward signal but it must be balanced with the need to keep everyone focused and incentivized. Financing rounds usually mark the beginning of a new and exciting growth phase, not the end of the joint journey."
>
> *Elias Börgmann-Dehina*, General Counsel at Headline Ventures

2.4 Motivation and Incentives

It is a truism, "owners" work harder for their businesses. Employee Ownership, if done right, is supposed to instill this feeling of ownership in employees. In his first letter to *Amazon*'s shareholders after the company went public in 1997, *Jeff Bezos* wrote: "We will continue to focus on hiring and retaining versatile and talented employees and continue to weight their compensation to stock options rather than cash. We know our success will be largely affected by our ability to attract and retain a motivated employee base, each of whom must think like, and therefore must actually be, an owner". The hope is that a direct financial interest in the company's outcomes inspires proactive, solution-oriented behavior and encourages employees to work harder as well as be more ambitious. Or as Silicon Valley legend *Steve Blank* put it in a 2019 article in the *Harvard Business Review* when looking back at the time when the issuance of options became popular among Bay Area start-ups: "And the bet worked. It drove the relentless 'do whatever it takes' culture of 20th century Silicon Valley. We slept under tables and pulled all-nighters to ship products and make quarterly revenue—all because it was 'our' company".

Beyond the usual start-up folklore, there's actually some data to back this up. While the sample sizes are small and the relationship between culture and ownership is about as straightforward as a cap table after five funding rounds, an analysis by the service provider *Glassdoor* suggests that U.S. companies with a strong Employee Ownership culture score higher with their teams and experience less churn. Many of our clients would agree. They often credit their ownership culture as the secret sauce that got them through the recent Plague (otherwise known as COVID-19—remember that?), as well as the funding rollercoaster that followed. That "we're in this together" spirit kept teams engaged and motivated—even when everyone was dialing in from their kitchen tables.

AWARDS FOR ADVISORS & CO.

We are frequently asked whether Awards under a German market Employee Ownership program can also be used to incentivize non-employees, *e.g.*, advisors or even service providers. Yes, they can, but you should check with a tax advisor on the details as granting of Awards often requires an invoice and has VAT implications.

But let's leave the technical nuances aside, granting Awards to non-employees can sometimes be a good (though as we will see long-term maybe pretty expensive) way to preserve liquidity or give the newcomer access to talent that it would otherwise not have.

Indeed, some non-employees got really lucky when they rolled the dice.

Of course, we fall victim to the survivorship bias once again and only read about the (very few) real success stories but some of them are just too good. Like the story of *David Choe*, the graffiti street artist who in 2005 took *Facebook* stock options instead of a USD 60,000 cash payment for painting murals at the social network's first headquarter. Pretty smart bet, those shares were rumored to be worth more than USD 200 million when the company went public in 2012 (although it is not entirely clear whether he had by then already sold some of the options on the secondary market) making this office graffiti one of the most expensive pieces of art of all times.

Ready for another story?

In 2011, *Bradley Tusk* was an ex-manager who started his own firm based in New York City and was named one of the "Top 20 most influential people in New York City". As a favor to a friend, he met up with a guy from an unknown transportation start-up. "We have this conversation. He says, 'Can I hire you?' I say, 'Sure, our minimum would be USD 25,000 per month.'He comes back, 'You know what? I can't do USD 25,000 per month. Can we do some equity?'" Tusk said "yes"—which turned out to be a good idea. His client was *Uber*. Years later, his stake in *Uber* was rumored to be worth around USD 100 million.

There's a fine line between creating an ownership mentality and creating an entitlement mentality. When equity becomes expected rather than earned, it can lose its motivational power. The goal is to create owners, not just equity holders. In addition, when everyone has equity, everyone has opinions about company strategy, valuation, and exit timing. While this can lead to valuable insights, it can also create communication challenges and unrealistic expectations. *Franz Hahn*, general counsel at the renowned German venture capital investor *Picus* had this to share: "When allocating stock options, don't treat it as a nice add-on for everyone. Position it as a core component of compensation for your most committed people—a genuine opportunity to participate in the value you're creating together. Only then will it help you create a sense of real co-ownership, preserve liquidity, and justify the dilution. For lasting retention, avoid over-engineered vesting structures. Instead, use repeated allocations with renewed vesting at standard terms to maintain engagement and long-term alignment".

2.4.1 Communicating the Value of Employee Ownership

Here, a note of caution is warranted. A great corporate culture does not automatically translate into a great ownership culture. The latter requires employees to truly understand the Employee Ownership program and to identify as owners. If not communicated effectively, the benefits of Employee Ownership may seem abstract or irrelevant to employees' day-to-day work.

According to *Carta*'s 'State of Start-up Compensation Report' for H2/2024, in the U.S., the percent of vested, in-the-money employee equity grants exercised before expiration dropped to 32.2% in Q4/2024, close to its all-time low since 2017 (32.0% in Q4/2023). However, to put this into perspective, that number peaked at 54.2% in Q4/2021 at the height of the funding bonanza.

In our experience, many employees struggle to grasp what Employee Ownership actually means and end up with an unrealistic perspective on their Awards or do not appreciate them enough. Founders and leadership must work hard to communicate the value and mechanics of Employee Ownership and to foster engagement. As with most things in start-ups, one size fits nobody—each company needs to find its own approach and adapt as it grows.

"An effective employee incentive plan is built on clear communication. When designing it, make sure it's not just legally sound but also worded and designed clearly and transparently—think of it as a product, not just a legal document."

Franz Hahn, General Counsel at Picus Capital

From working with countless start-ups, we have distilled a brief overview of some of the tools and practices start-ups have at their disposal to communicate and promote their programs.

Accessible Summaries and FAQs: Most start-up clients provide high-level summary presentations and FAQ sheets that explain the plan's mechanics and translate financial jargon and legal fine print into clear, relevant key points. While we think that it suffices to have the Employee Ownership program itself prepared in the English language only, it certainly helps to have FAQs in multiple languages to make the main legal documents more accessible. However, all beneficiaries should still be strongly encouraged to read the plan itself and, if needed, consult their own advisors to fully understand the risks and rewards.

Interactive Tools and Visuals: Effective communication of the value proposition inherent in Employee Ownership programs would be significantly enhanced by moving beyond mere program documentation to implementing comprehensive digital tools that provide real-time transparency and forward-looking projections (don't worry, us lawyers will make sure that there will be sufficient disclaimers in bold letters included...). Such tools should enable employees to access current vesting status across their various Award allocations at any time, while also modeling future development scenarios based on continued employment and projected company valuations.

One late-stage client created an entertaining explainer video that summarized the plan's main features and introduced an interactive tool. This tool allowed employees to enter just a few numbers about their personal Award allocation (size, strike/base price and vesting start date), dream up a potential exit valuation for the company and see potential scenarios for the value of their Awards—making the benefits tangible and relatable or as one of the authors of this Guide lamented: "They distilled my 25 pages into four numbers?"

Interactive platforms that can estimate potential payout scenarios based on assumed per-share values or company valuations at exit would transform how employees perceive and engage with their equity participation. These tools help translate abstract program concepts into tangible, visual representations that employees can readily comprehend. When employees can see what continued tenure means for their personal "equity portfolio", the retention and motivation effects of Employee Ownership programs are amplified. For programs that incorporate negative vesting provisions (the challenges of which we will address in subsequent chapters), such tools become even more critical.

They can clearly illustrate the consequences of departure and the impact of negative vesting, helping employees make informed decisions about their career trajectory while understanding the full implications of their choices within the program structure.

Perhaps the German market remains too fragmented, or the variations in program structures too numerous, but the authors of this Guide are not aware of any truly satisfactory solution that addresses these communication challenges while simultaneously enabling companies to administer their entire programs with minimal effort and maximum efficiency. The ideal platform would combine employee-facing transparency tools with robust back-end administration capabilities, creating a comprehensive ecosystem that serves both participant engagement and operational efficiency needs.

ESOP Communication Committees: Some start-ups go a step further and establish dedicated "ESOP Communication Committees". These committees can then play a crucial role in building and maintaining an ownership culture. Their responsibilities typically include:

- **Plan Communication:** Developing and delivering clear, engaging communications about the Employee Ownership program, including regular updates and reminders.
- **Onboarding Support:** Offering one-on-one info sessions for new joiners to explain the plan and answer questions.
- **Feedback Collection:** Gathering feedback from employees about the plan's clarity and perceived value and relaying this input to leadership for future plan improvements.
- **Ongoing Education:** Organizing workshops, Q&A sessions, and "ESOP Days" to keep the topic top-of-mind and to demystify complex concepts. For example, one of our clients is a Berlin-based SaaS company and has established an ESOP Committee that meets quarterly to review employee questions, update educational materials, and coordinate with HR to ensure that Employee Ownership information is part of every new hire's onboarding. Another client holds an annual "Ownership Week", featuring workshops, fireside chats with founders, and real-life stories from employees who have benefited from the program.

Transparency and Regular Updates: Leading start-ups make a point of sharing regular updates on company performance, valuation, and how these impact the potential value of Awards. Some even provide annual "ESOP statements" to each participant, showing their current holdings and potential future value under different scenarios.

2.4.2 Awards for All or Selected Employees?

When motivation and identification with the start-up are universally desirable attributes in employees, founders frequently find themselves wrestling with a fundamental question: "Should all employees get Awards?" Here, in the start-up and investor community you will find proponents of the "Great ESOP Democracy Party" on the one side while their opponents warn against turning your equity pool into a participation trophy ceremony.

According to a survey published by *Handelsblatt* in January 2023 among some of the German unicorns, a mixed picture emerged. According to Handelsblatt's findings, at *Staffbase* every employee who works at least 25 hours per week gets the opportunity to receive Awards. At *Celonis*, *Commercetools*, and *GetYourGuide*, the entire workforce can also participate in Employee Ownership programs. However, at many other start-ups, employees only benefit from a certain seniority level onwards. For example, the Berlin fintech *Raisin* offers Employee Ownership from the middle management level upwards. At *Sennder*, for instance, all employees who carry initial personnel responsibility can acquire Awards.

It's a question that has sparked more heated debates in Silicon Valley boardrooms than whether pineapple belongs on pizza (spoiler alert: it doesn't, it really doesn't). The answer, like most things in the start-up world, is frustratingly nuanced and depends on factors ranging from your company stage to your cultural values to whether your CFO has had their morning coffee.

> "The key is to be thoughtful about equity distribution. You want everyone to feel like an owner, but you also need to ensure that the people who can most impact the company's success have the strongest incentives to stay and perform."
>
> *Reid Hoffman*, LinkedIn founder

Seriously, in this Chapter we want to briefly present the main arguments for both sides and outline what we personally think might work for many start-ups.

The Case for Universal Awards – "We're All in This Together": There are a couple of reasons lending support to a more generous approach where Awards are given to all or most employees (though obviously individual allocations might differ here as well):

- **The Cultural Catalyst:** Giving Awards to all employees can be a powerful cultural tool that transforms your workplace from a collection of individual contributors into a unified ownership society. When everyone has skin in the game, sometimes something magical happens: the janitor starts turning off lights to save on electricity costs, the receptionist becomes your most passionate brand ambassador, and suddenly everyone cares about growth metrics and KPIs like they're checking their own bank account (because, in a way, they are).
- **The Motivation Multiplier:** When employees know they're not just earning a paycheck but building something they partially own, their relationship with work can shift (at least that is what one would hope for). They stop watching the clock and start watching the competition. Ideally, they begin thinking like owners because, well, they are owners. As one of our (craftier) colleagues likes to put it in his presentations: "It's the difference between renting and owning a house—renters might not care if the paint is peeling, but homeowners are out there with a brush on Saturday morning".
- **The Retention Revolution:** In today's talent market, where developers change jobs more frequently than they change their GitHub profile pictures, universal equity can be a powerful retention tool. When employees have unvested Awards, leaving becomes a financial decision, not just a career one. Research by the *National Center for Employee Ownership* indicates that U.S. companies with broad-based equity programs have lower annual turnover rates compared to companies without such programs (though with 2-3 percentage points difference, the impact doesn't seem to be dramatic).

"Equity isn't just about money—it's about creating a culture where everyone thinks like an owner. But that doesn't mean everyone needs to own the same amount."

Melanie Perkins, Canva CEO

The Case Against Universal Awards – "Football Superstars Sell More Jerseys": Let us now look at some of the main arguments for a more focused approach that concentrates Awards on a subset of the start-up's workforce.

- **The Dilution Dilemma:** Here's where math becomes the villain in our start-up story. Equity is not an infinite resource. When you spread Awards across every employee, you're essentially playing a zero-sum game where giving more to everyone means giving less to the people who might have the biggest impact on your company's success. As venture capitalist *Ben Horowitz* puts it: "The story of the start-up is the story of the team, but not every team member plays the same position". With tribute to our American colleagues and their peculiar favorite pastime: Some employees are your *Tom Brady* (the quarterback who could single-handedly change the game), while others are excellent but replaceable players. Universal equity distribution can mean your star performers get the same slice as everyone else, which might not reflect their actual contribution or market value.
- **The Peanut Butter Problem:** Remember *Yahoo*'s infamous "Peanut Butter Manifesto"? In 2006, *Yahoo* executive *Brad Garlinghouse* wrote an internal memo criticizing the company for spreading resources too thinly across too many initiatives, like peanut butter on bread. The same principle applies to equity distribution. When you spread Awards too thinly across all employees, you risk creating a situation where high performers don't feel adequately rewarded, the economic incentive becomes too small to drive meaningful behavior change and you run out of equity pool for future key hires.
- **The Performance Paradox:** Not all employees are created equal, and pretending they are can actually demotivate your top performers. If your rockstar engineer who works 70-hour weeks and ships game-changing features gets the same Employee Ownership percentage as someone who does the bare minimum, the founders send a message of what they value whether intended or not. For example, *Netflix* moved away from broad-based equity programs, with *Reed Hastings* explaining: "We're a team, not a family. We're like a pro sports team where we're trying to win championships, and that requires having the best person in every position".

In this context, another "con" that is sometimes raised against broad-based Employee Ownership is the free-rider problem. Employees can free-ride on the efforts of their colleagues while still getting the same economic outcome. However, while free-riding is often an important factor in group incentive questions, start-up teams are often relatively small and "employee owners" are often willing and able to enforce higher workplace norms and take action against shirking co-workers, especially in environments that support employees and inspire loyalty.

ALL EMPLOYEES ARE EQUAL—RIGHT?

German law requires that the employer must comply with the principle of equal treatment. Thus, eligible employees under an Employee Ownership program may not be chosen in a discriminatory manner or in breach of equal treatment rules. This means that, for example, any (direct or indirect) differentiation based on race, ethnic origin, gender, religion or belief, disability, age or sexual identity is strictly prohibited. A differentiation by groups is permissible if the group of beneficiaries can be clearly distinguished from the group of excluded employees. However, a general exclusion of part-time employees because of their reduced working hours would be unlawful. The consideration of only a particular hierarchical group may, on the other hand, be justified.

The Middle Ground – Strategic Award Distribution: Even though *Aristotle's* doctrine of the golden mean probably focused more on virtues than on issues of distribution in Employee Ownership (who knows...), the truth here too often lies, well, in the middle.

Perhaps the most pragmatic approach is to let your company's stage guide your equity philosophy.

- **Early Stage (Pre-Series A):** When you're a small team of 5-15 people, everyone is wearing multiple hats, and everyone's contribution is genuinely critical. Your designer is also your customer service rep, your engineer is also your IT department and your marketing person is probably also making coffee runs. At this stage, broad equity distribution (of moderately sized Awards) makes sense because everyone truly is essential to survival, not to mention that without some Award promises, these people might not even consider joining your team in the first place.
- **Growth Stage (Series A and Series B):** As you scale to 50-100 employees, you start having more specialized roles and clearer performance differentials. This is where you might transition to a more merit-based approach while still ensuring everyone has some ownership stake. Think of it as moving from "everyone gets a trophy" to "everyone gets a ribbon, but the winners get the MVP trophy". (Hint: if you are thinking "minimum viable product", you need to watch more sports). This doesn't mean abandoning universal equity entirely but rather evolving toward a system that balances cultural benefits with performance incentives.
- **Later Stage (Series C+):** When you're hundreds of employees strong, universal meaningful equity becomes mathematically challenging and potentially counterproductive. At this point, you might focus larger Awards on key performers and critical roles while closing the Employee Ownership program for certain groups of the workforce or offering them only more symbolic allocations.

Many successful companies have also found success with moving to a hybrid model over time:

- **Base Layer:** Everyone gets some equity—enough to feel like an owner but not enough to break the bank. This satisfies the cultural and motivational benefits of universal ownership.
- **Performance/Position Layer:** Additional Awards are based on performance, role criticality and market rates. This ensures your top performers feel valued and your key positions remain competitive.

This model also allows for sufficient flexibility to address special situations, for example, extra Awards for exceptional contributions, retention purposes or strategic hires.

> "We've always believed that everyone should have equity, but the amounts should reflect both the value they bring and the risk they're taking by joining us."

Drew Houston, Dropbox CEO

We believe that the key is being intentional about this evolution. Don't let your equity strategy happen by accident—design it to support your company's goals at each stage of growth. While there is no one-size-fits-all solution, it is important to remember that transparency is fundamental. Employees can accept different Award levels if they understand the logic. What they can't accept is feeling left out or treated unfairly.

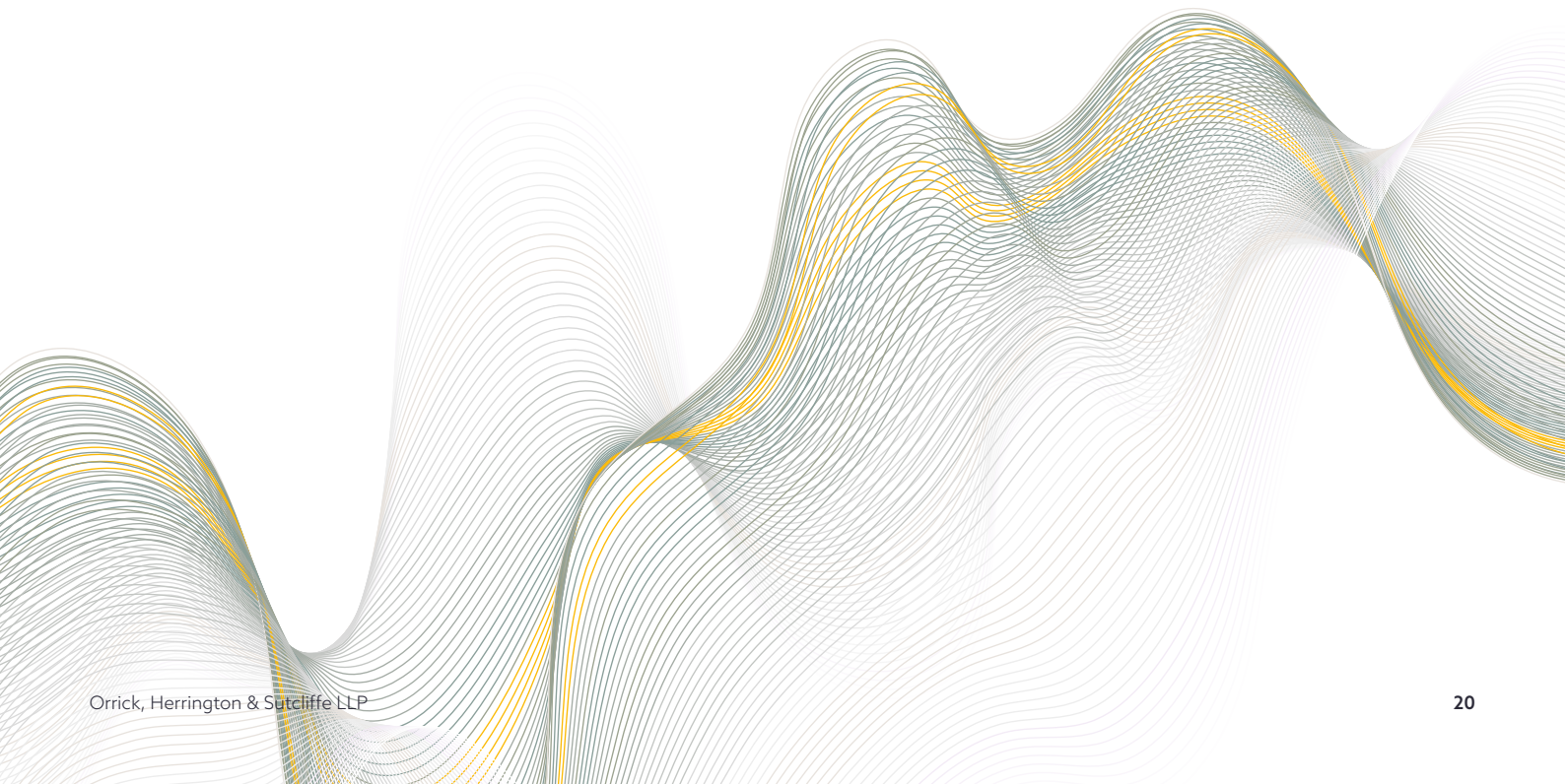
3. EMPLOYEE OWNERSHIP – THE ANGEL AND START-UP ENGINE

There is another more macro-economic consideration for giving employees (ideally in a tax-efficient way) Awards. Successful exits can start a powerful cascade effect, where staff cash in their Awards in the case of a successful sale or IPO of their start-up, creating wealth that can be funneled back into new start-ups and spin-offs, which in turn creates a new group of cash-rich entrepreneurs. For example, in the tech hotbeds of the United States, thousands of employees across hundreds of start-ups have benefited financially following company exits. Those alumni, endowed not only with investable capital but with an appetite for risk and innovation, then went on to found companies of their own or became angel investors themselves, creating a virtuous cycle of funding, founding, innovation and financially rewarding exit that feeds itself.

According to some media reports, the *Google* IPO in 2004 made about 1,000 of its then 2,300 employees millionaires while catchy rumors around the *Facebook* IPO in 2012 said that the then record-breaking public debut would also produce "well over 1,000 millionaires" overnight (according to reports by the *Daily Mail*). (*Facebook* had somewhat over 3,000 employees at that time.)

"In Hamburg, for example, there is not yet as much liquidity in the start-up ecosystem as in say Berlin. If, for example, 40-50 of our employees were to receive a significant payout through an IPO now, this would trigger a major leverage effect for the Hamburg start-up ecosystem through a new wave of start-ups."

Tarek Müller, Co-Founder at AboutYou—note: convenience translation by the authors



4. THE MAIN DIFFERENCES BETWEEN EUROPEAN AND U.S. EMPLOYEE OWNERSHIP

The experiences that founders and investors have accumulated in the United States over the past several decades, and the concepts and models developed during that time, remain hugely influential for tech hubs worldwide. Although this is certainly a multicausal phenomenon, the widespread adoption of (relatively) tax-favorable stock options in the United States is considered one of the strongest factors that fueled the growth of the United States VC and VC-backed start-up sector.

As a response to high uncertainty and transaction costs, U.S. VC investors developed a model in which key hires and sometimes subsequent co-founders are compensated with stock options that have delivered comparatively strong returns, supported by favorable tax treatment and well-established market practices. Against this background, many proponents of legislative reforms in Europe argue that emulating the U.S. approach to Employee Ownership is vital for European countries to remain competitive in entrepreneurial finance.

While obviously there is no such thing as a single "European start-up ecosystem" (come to think of it, there seems to be hardly any single European anything) and—wait for it—, here comes the promised quote from *Mark Twain*: "All generalizations are false, including this one", there are some differences between the "European" and the U.S. approach to Employee Ownership. Opposite is a summary of some of the key differences that we took from an excellent study published by the VC investor Index Ventures and updated with some of our thoughts.

Dimension	European Situation	U.S. Situation	Recent Developments
Overall Employee Ownership Levels	European employees own less of the companies they work for. For late-stage start-ups, they typically own around 8-12% versus 15-20% in the United States.	Higher baseline ownership levels, with late-stage start-ups typically allocating 15-20% to employees.	Gap has narrowed slightly but persists. European companies increasingly recognize the need for larger employee pools to compete for talent.
Consistency of Allocation	Ownership levels vary much more across Europe. Employee ownership in late-stage start-ups ranges from 4% to 25%, with significant country-by-country variation.	More consistent allocation patterns driven by established market benchmarks and competitive dynamics.	European markets are converging toward more standardized practices, particularly in major tech hubs like London, Paris, Berlin and Munich.
Technical vs. Non-Technical Bias	Employee ownership strongly correlates with how technical a start-up is. AI, deeptech and infrastructure companies allocate significantly more equity than SaaS or consumer-focused start-ups.	Similar correlation exists but is less pronounced due to broader baseline equity participation.	This pattern has intensified post-2020 as competition for technical talent has become global and remote work has increased mobility.
Policy and Plan Design	Significant variation in plan provisions (leaver policies, acceleration triggers, exercise periods). Less standardization across markets.	More standardized approaches to plan design, driven by established legal frameworks and market practices.	European practices are converging toward U.S. standards, particularly for VC-backed and internationally oriented companies.
Executive vs. Employee Distribution	Historically executive-biased, with 50-70% of Awards allocated to C-level and VP roles, leaving only 30-50% for broader employee base.	More balanced distribution, typically 40-50% to executives and 50-60% to broader employee base.	This gap has narrowed significantly as European companies adopt broader-based equity programs.
Employee Expectations	European employees increasingly expect Awards, but expectations vary significantly by country and sector. In major tech hubs, expectations now mirror U.S. levels.	U.S. employees joining tech start-ups with fewer than 100 staff typically expect Awards as standard compensation component.	Expectations have converged, particularly among internationally mobile talent and in major European tech centers, although at the top of the talent pyramid, United States employees still get a lot more.
Regulatory Environment	Wide variation across European countries. United Kingdom (EMI), France (BSPCE) and Germany (sec. 19a EStG) offer favorable frameworks. Other countries lag significantly.	Relatively consistent federal framework (ISO/NSO) with state-level variations. Well-established 409A valuation processes.	Recent reforms in Germany, ongoing improvements in other EU countries, but significant fragmentation remains.
Valuation and Administration	Less standardized valuation practices. 409A-equivalent processes emerging but not universal. Higher administrative complexity due to multiple jurisdictions.	Standardized 409A valuation requirements. Mature service provider ecosystem. Consistent administrative practices.	European infrastructure is rapidly maturing, with specialized service providers and more consistent valuation practices emerging.
Exit Market Maturity	Smaller exit market with fewer large outcomes. IPO markets less developed for tech companies. M&A market growing but still smaller than the United States.	Large, liquid exit markets. Well-developed IPO ecosystem. Active M&A market providing multiple exit paths and deeper secondary markets for pre-exit liquidity.	European exit markets have strengthened, though still smaller than United States Scale of outcomes has increased but, in particular, European IPO market lags the United States substantially.

Despite persistent differences, the findings above are determined by several accelerating convergence trends:

- **Globalization of Talent Markets:** Remote work and global talent competition have forced European companies to adopt more competitive equity practices, often matching or exceeding U.S. standards for key roles.
- **Investor Influence:** United States and international VCs investing in European companies bring established equity practices and expectations, driving standardization.
- **Regulatory Improvements:** Recent reforms in Germany (Section 19a EStG), ongoing improvements in France and the United Kingdom's continued leadership in employee equity have narrowed the regulatory gap.
- **Infrastructure Development:** European markets now have access to sophisticated equity management platforms, valuation services and legal expertise that previously gave U.S. companies significant advantages.
- **Success Stories:** High-profile European exits (*Klarna*, *Spotify*, *AboutYou*, *Delivery Hero*, *etc.*) have demonstrated the value of broad-based employee equity, encouraging wider adoption.

The gap between European and U.S. Employee Ownership practices continues to narrow, particularly in major tech hubs. European companies increasingly recognize that competitive equity programs are essential for attracting and retaining top talent in a global market. While regulatory and cultural differences persist, the fundamental trend toward convergence appears irreversible, driven by global competition for talent and the demonstrated success of broad-based Employee Ownership in creating value for all stakeholders.

The next phase of European Employee Ownership evolution will likely focus on further regulatory harmonization, continued infrastructure development and the emergence of distinctly European approaches that leverage the region's strengths while learning from U.S. best practices.

5. BEYOND THE EXIT – ALTERNATIVE INCENTIVE SCHEMES

While this Guide focuses on exit-driven incentive programs—where employees "cash in" alongside founders and investors at a sale of the company or its IPO—not every company is built for an exit. Some founders want to create sustainable, long-term businesses, perhaps even a hidden champion (German way of describing a medium-sized enterprise, characterized by its dominant market position in a specific niche) that remains independent for decades. For these companies, alternative incentive schemes can still give employees a meaningful stake in the company's success, while supporting a culture of long-term engagement and steady growth.

These non-exit-driven models are often more flexible and can be easier to implement from a governance perspective as they are by design usually meant to keep the cap table clean, *i.e.*, not issue shares to beneficiaries.

Whether the goal is a high-profile exit or a multi-generational business, the right incentive structure is a cornerstone for attracting, motivating and retaining the people who will determine the company's future—no matter how long the journey may be.

While a full deep-dive into non-exit-driven incentive schemes deserves its own edition of the OLNS, here are some of the most relevant alternatives:

5.1 Bonus Schemes – More Than Just a Year-end Thank You

Bonus schemes are the classic alternative to equity-based plans. But to truly drive long-term value and retention, they need to be more sophisticated than a simple annual payout for hitting last year's targets. The most effective bonus plans are structured with a multi-year horizon, combining performance metrics with retention elements.

How can this work in practice?

Multi-year Performance Periods: Instead of rewarding only last year's EBITDA or revenue growth, the scheme can measure performance over three or even five years. This approach encourages employees to focus on sustainable growth, not just short-term wins.

Forward-looking KPIs: Bonuses can be tied to a mix of financial (*e.g.*, EBITDA, revenue, cash flow) and operational (*e.g.*, market share, customer retention, product launches) metrics. Some companies use "balanced scorecards" that combine several KPIs.

Deferral and Vesting: A portion of each year's bonus pool can be structured as a retention payment, *i.e.*, be paid out only if the employee remains with the company for a certain period (*e.g.*, three years). This "bonus bank" or "rolling pool" approach bakes in a retention element: leaving early means forfeiting some or all of the deferred retention payment.

Long-term Value Creation: To further align interests, some companies link bonus payouts to the company's cumulative value creation—such as average annual growth in enterprise value, or achievement of strategic milestones (*e.g.*, entering a new market, launching a new product line). To put more focus on long-term value creation, the scheme can also foresee that irrespective of the beneficiary leaving the company or not if certain KPIs deteriorate after the bonus period, the deferred bonus payment gets reduced during the cash-out period.

Example: A German industrial tech company implemented a three-year bonus plan where 50% of the annual bonus is paid immediately for hitting EBITDA and customer satisfaction targets, while the remaining 50% is structured as a retention payment and only paid if the employee is still with the company at the end of the three-year cycle. If the company's average EBITDA growth over the period exceeds a certain threshold, the retention portion is "uplifted" by a multiplier.

5.2 Stock Appreciation Rights (SARs) and Value Appreciation Rights (VARs)

Stock Appreciation Rights ("SARs") and *Value Appreciation Rights* ("VARs") are financial instruments that let companies share an increase in their valuation without sharing the ownership and without requiring a liquidity event.

What Are SARs and VARs, Really? Think of SARs and VARs as "phantom equity"—they mirror the value appreciation of real equity but exist only on paper until they're cashed out. Here's the key difference:

- SARs are tied to actual stock price appreciation; and
- VARs are tied to company value appreciation (which may or may not correlate directly to stock price).

Consider a tech company that grants an employee 1,000 VARs when the company is valued at $10 million. The company has established a VAR pool representing 10% of the company's fully-diluted value, and there are 100,000 total VAR units in the pool. This means each VAR unit represents 0.001% of the company's value ($10 million ÷ 100,000 units = $100 per unit at grant). The VARs vest over four years at 25% per year. After two years, 50% of the VARs have vested (500 units). If the company is now valued at $20 million, each VAR unit is worth $200 (the VAR pool is still 10% of company value: $ 20 million × 10% ÷ 100,000 units).

Depending on the program's design (exercise window, maximum number of VARs that can be exercised, *etc.*) the employee can choose to:

- cash out their 500 vested units and receive: 500 × ($200 - $100) = $50,000 in cash;
- hold onto them hoping for even greater appreciation; or
- cash out partially and hold onto the rest.

Both work on the same basic principle: employees get rewarded based on how much the company's value increases during the time they hold such instruments, but they never actually own shares.

Why do companies like SARs/VARs?

- They are less dilutive than traditional stock options, as no new shares are issued.
- They provide a clear, cash-based reward for value creation—even without an exit.
- They can be customized to fit the company's business model, growth stage and retention goals.

The employee receives the payment without ever having to buy shares, exercise options or wait for an IPO or acquisition. Their payment entitlement represents their proportional share of the company's value appreciation. The obvious drawback for the company is that these programs result in liquidity drains prior to an IPO or exit which might be particularly painful during economic downturns or high-growth phases. Accordingly, most plans foresee caps on the number of vested SARs or VARs that can be exercised or limit the entire payment amount for a particular exercise window.

Payout Events: The payout can be triggered by various events: periodic company valuations (*e.g.*, annual, biennial), achievement of specific financial or operational milestones or at the employee's discretion after a vesting period.

No Exercise Price: Unlike traditional stock options, SARs/VARs do not require employees to pay an exercise price. Employees simply receive the value of the appreciation—typically in cash—making the benefit tangible and accessible.

The Valuation Challenge: The biggest complexity with SARs/VARs is determining company value, especially for private companies. Common approaches include:

- **Formula-based:** Using revenue multiples, EBITDA multiples or other financial metrics.
- **Independent Appraisals:** Annual or biennial third-party valuations.

III. "Real" or "Virtual"? What Kind of Programs Are Available?

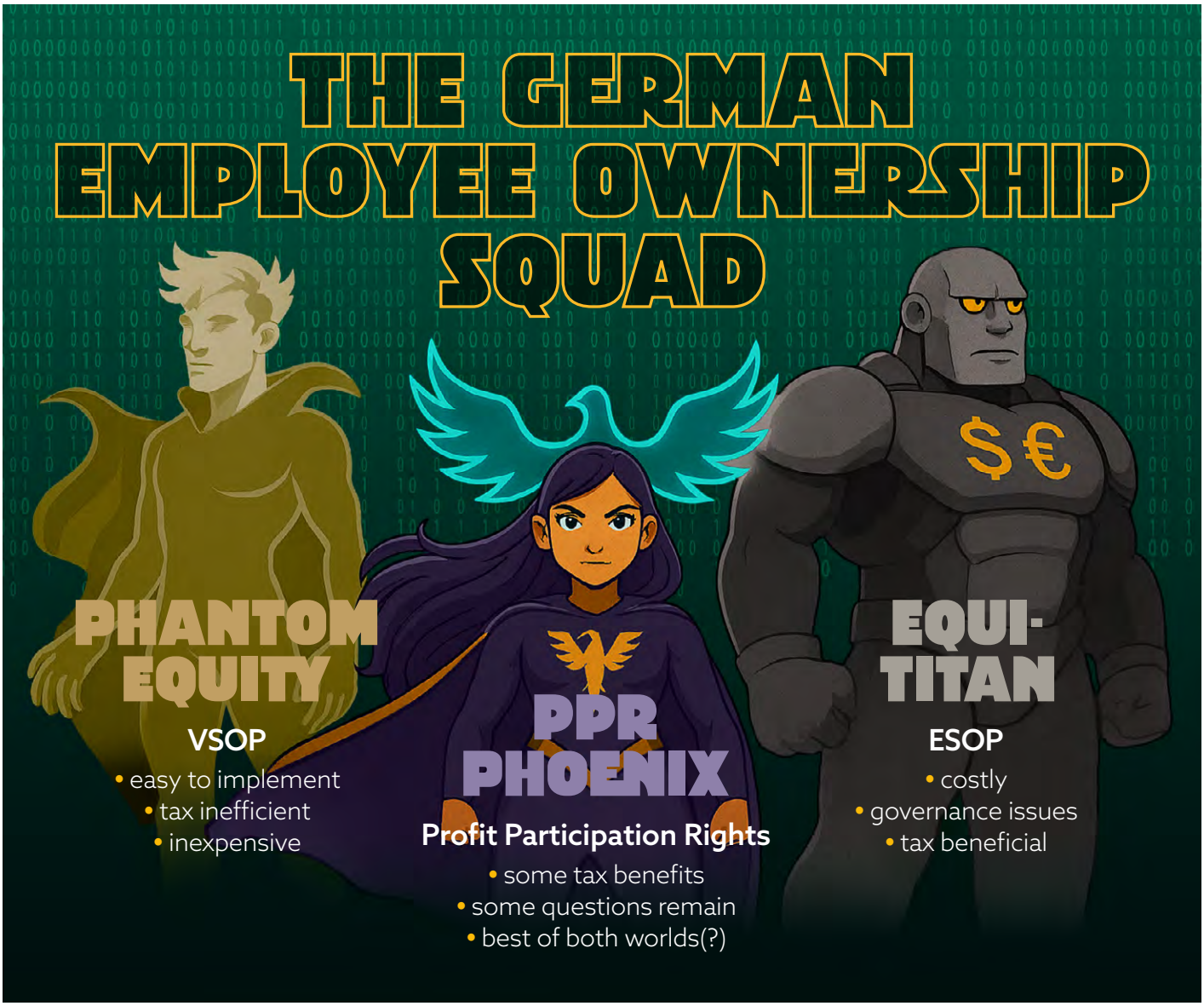
In this Chapter, we want to provide an overview of the available programs and their main pros and cons, while in subsequent Chapters, we will take a closer look at the main features and design elements of such programs.

We think it makes the whole topic more accessible when first explaining the various fundamental structuring options for Employee Ownership plans that are available before discussing the nuts and bolts of vesting and leaver provisions, *etc.*, as the latter apply in one way or another to ESOPs and VSOPs alike (although their practical implementation might differ). So here we go:

1. OVERVIEW

When designing and managing such schemes, the choice between Employee Ownership structures is driven by

- tax efficiency,
- corporate governance constraints,
- administrative scalability, and
- investor expectations.



Here, start-ups can broadly choose between VSOPs and ESOPs, the latter being an umbrella term for real shares, options for real shares and equity-like instruments such as the PPRs. Let's look at each of them in turn:

VSOPs represent a distinctive approach to Employee Ownership that replicates the economic characteristics of ESOPs while avoiding the complexities of actual share transfers.

In the light of day, a VSOP is the lawyers' elaborated, 20+ pages long way to describe an exit-triggered cash bonus. Basically,

- the beneficiary receives a cash payment from the company in case of an exit; and
- the amount of such cash payment is based on, among other things, how much the holder of a common share receives in the respective exit event (or a fraction thereof) usually minus some form of strike price or base price as deductible.

This structure operates through a purely contractual framework, deliberately circumventing the need for genuine share or option issuances. Because they seek to economically (though not taxwise) mimic the outcome for a holder of a common share (who acquired such common share by exercising a stock option and paying a purchase price), VSOPs are sometimes also referred to as "phantom equity".

From a tax point of view, VSOPs have the advantage for the beneficiary that taxation only takes place when the exit occurs and the beneficiary is actually entitled to the cash payment, *i.e.*, when they have the financial means at their disposal to pay the tax liabilities. The infamous "dry income" that we will discuss in a minute doesn't plague VSOPs. However, payments under VSOPs are subject to the high income/wage taxation and do not allow for capital gains taxation. The same applies to the termination of the respective virtual participation. Thus, any severance payments or "buy-back payments" upon termination of virtual participations under a VSOP are also subject to the deduction of wage tax and social security contributions at the time of payment.

On the positive side with a VSOP, the strike price is a mere deductible when calculating the beneficiary's payment claim and does not have to be actually paid by the employee.

With their low overall complexity and costs, VSOPs are still arguably the "easiest" instrument to implement and scale in practice, particularly as there are still practical challenges with equity-linked programs such as PPRs (more on that further below), which make them slower to implement and more costly. However, this advantage comes with the drawback that the entire increase in value up to the exit is subject to income/wage tax.

ESOPs are equity-based programs that

- grant employees "real" shares (that can be either held by the beneficiary themselves (directly or through a special purpose vehicle) or indirectly through a pooling or trust vehicle);
- grant employees the right to acquire an actual shareholder position upon exercising options; or
- provide neither real shares nor options for real shares but can be thought as of an equity-like instrument (notably PPRs fall into this category).

These different schemes all have in common that they seek to strike a balance between the goal of getting the beneficiary to a more tax-favorable outcome compared to VSOPs while not creating (too many) corporate governance issues and keeping the implementation and administration costs reasonable.

With the granting of real shares, the beneficiary becomes a true shareholder with all associated rights—usually voting, dividends, rights to information, attend the shareholders' meeting, *etc*. The main advantage is that, if structured and timed correctly, future gains on these shares can qualify for favorable capital gains taxation. However, real shares also come with corporate governance implications: every new shareholder has legal rights under German law, which can complicate decision-making and cap table management, especially as the number of employee shareholders grows. Notarization requirements and dry-income taxation (taxation before liquidity) are additional hurdles that need to be addressed. We will discuss these issues in detail in a second.

With share options, employees are granted options that entitle them to acquire real shares in the company at a predetermined price (the "exercise price" or "strike price") once they have become vested and, to delay governance issues usually only once an exit is imminent. This structure is familiar from international tech markets but never gained a lot of traction in Germany as their most common structures do not provide meaningful tax benefits.

PPRs are equity-like instruments that provide employees with an economic stake in the company's success—typically a share in profits, and when used for Employee Ownership plans also in exit proceeds—without conferring formal shareholder status. PPRs can be structured flexibly and, if designed in line with the requirements of sec. 19a EStG, can benefit from wage tax deferral and capital gains treatment on future appreciation. Because PPRs do not require notarization and do not create new shareholders, they are attractive for companies that want to avoid the administrative and governance complexity of a crowded cap table. However, the legal and tax structuring of PPRs is still evolving, and their practical implementation is still more complex than a classic VSOP.

This co-existence of ESOPs in variations as well as VSOPs is a particularity of the German ecosystem especially when compared with the situation in the United States where ESOPs (in the form of stock options and restricted stocks) are the standard. The next Chapters will dive deeper into the issues with ESOPs in the German market and what this means for German start-ups.

2. WHAT IS THE ISSUE WITH ESOPS IN GERMANY?

You might start to wonder, why Employee Ownership isn't universally adopted in German start-ups and why there are multiple forms of Employee Ownership approaches in Germany encompassing virtual, equity and equity-like structures compared to for example the technology hotbeds in America where we don't see so many different structures. So, what are the issues here?

To answer this question, let us look at two central drivers behind most Employee Ownership structures and discuss how they impact the design of such programs in Germany:

- taxes and timing of taxation; and
- governance issues and cost implications.

Spoiler, these are the two Achilles' Heels of ESOP, though as we will see maybe there is only one going forward (eventually)...

2.1 Taxes and Timing of Taxation

From a tax perspective, two topics are regularly central for employees:

- **The Time of Taxation:** From the employee's point of view, the employee should only be taxed when money or "liquidity" is received. If a tax arises before this point in time, which the employee has to finance, so-called "dry income" arises.
- **The Level of Taxation:** In most Western taxation systems, the tax rates of individuals for income from employment and for capital income differ. The tax rates for capital income are lower than those for income from employment. In Germany, this difference amounts to almost 20 percentage points (max. total income tax burden (including solidarity surcharge (*Solidaritätszuschlag*) but without church tax (*Kirchensteuer*)) on the sale of shares in a corporation held as private assets: 26.375%, in case of a share of less than 1% or 28.485%, respectively, in case of a minimum 1% share vs. max. total income tax burden (including solidarity surcharge but without church tax) on earned income: 47.475%). Accordingly, it is clearly more advantageous for employees if capital income flows from the employee participation.

Tax consequences of employee participation can typically arise both in jurisdictions where the employee is liable to tax and—to the extent that the employee is employed by a foreign employer—also in jurisdictions where the employer is resident.

Please note that the tax assessment must be carried out in each individual case on the basis of the existing or planned Employee Ownership program and its tax consequences determined carefully. Comprehensive tax advice should be obtained for this purpose. In this Guide we can only provide for an overview of some of the crucial issues of Employee Ownership programs under German tax law.

2.1.1 The Dry Income Issue and the Two Ways to Address It

Let's dive deeper into the dry income issue before we will have a look at two mitigation approaches.

- **Dry Income – Basics:** In a nutshell, if beneficiaries are granted real shares at a discount, *i.e.*, below such shares' fair value or even for free (which is what the parties desire as the beneficiary will usually not be able or willing to make a significant upfront cash investment), this will generally trigger wage tax on the non-cash benefit provided to the beneficiaries. As a reminder: the non-cash benefit is the spread between the acquisition price paid by the beneficiary (if any) and the shares' fair value upon grant. The beneficiary would be taxed at a time when they get no liquidity. From the beneficiary's point of view, the beneficiary should only be taxed when money is received.

  If a tax arises before this point in time, which the beneficiary has to finance, so-called "dry income" arises. Taxes on dry income must be financed from other (private) funds of the beneficiary, from loans or deferred income.

Brief Excursus – How to Determine the Fair Value: The decisive factor for the avoidance of dry income—or for the amount of taxation at the time of its accrual—is therefore the "fair value" of the shares. The lower the fair value, the lower the price to be paid by the beneficiary to avoid dry income, respectively the lower the tax due will be in case of acquisition at a discount. Under German tax law, this question is to be answered on the basis of the German Valuation Act (*Bewertungsgesetz*—"**BewG**") and the valuation procedures laid down therein. If there are no fixed reference prices, the valuation is often fraught with uncertainties and prone to dispute. The following valuation criteria apply:

- If the shares in a corporation are tradable on the regulated market of a German stock exchange, the value is generally to be determined on the basis of the market value at the time of transfer. The valuation is more difficult regarding shares in corporations that are not listed on the stock exchange. Pursuant to sec. 11 para. 2 BewG, the following assessment hierarchy applies (no distinction between the valuation of shares in domestic and foreign corporate):

  → If the fair value can be derived from sales between third parties less than one year ago, this value shall be used. Shares resulting from a capital increase are also considered sales in this sense. Difficulties in deriving the value from previous sales regularly arise in case of sales within the same group, small shareholdings, package sales ("package premium") as well as in connection with shares of another shareholding group that have advantages or disadvantages compared to the shares to be valued. The latter occurs particularly frequently: If an investor paid a price of EUR 100 for shares with a liquidation preference (preferred shares) in the last financing round, *e.g.*, eight months ago, what is the value of shares to be issued to the employee today that do not have this preference or even come with a negative liquidation preference in case of growth shares?

ISSUES WITH ESOP

Aspect	(Potential) Issues	Mitigation Approaches
Form Requirements	Issuance and re-transfer of shares in case of a leaver requires involvement of notaries.	No mitigation available for issuance and transfer of real shares. Profit participation rights (as an alternative to real shares) can be granted and terminated without notarization requirements.
Governance	Real shares come with certain unalienable rights (including information rights, right to attend shareholders' meetings and to challenge shareholder resolutions).	Real shares can be pooled in a so-called "**ManCo**" and the ManCo can be set up in a way so that it is controlled by the start-up's founders (and investors). Profit participation rights can be issued without such mandatory shareholder rights.
Impact on Future Financing Rounds	For practical purposes, all shareholders should become parties to the financing round's investment agreement and shareholders' agreement. This makes the issuance of real shares hard to scale beyond a few shareholders.	Similar to the mitigation strategies described under "Governance".
Tax Risks	The acquisition of real shares at a price below fair value is a taxable event at that point in time.	Reduction of tax incurred through Growth Shares or use of the tax deferral option under sec. 19a EStG (if available).

→ If the fair value cannot be derived from sales between third parties, it shall be determined on the basis of a valuation report. This valuation report shall be based on the method that an investor would also use for the pricing. In the opinion of the tax authorities, income-based methods (according to IDW S1 or other discounted cash flow methods) shall regularly not be applicable for growth companies, as they do not at all reflect the value of the shares in the approach.

- When determining the fair value on the basis of a valuation report, the so-called net asset value is always to be used as the minimum value, if it is higher than the figure according to the other methods employed. The net asset value is roughly determined from the sum of the fair values of the assets and debts belonging to the business assets. Goods not included in the balance sheet, such as self-created IP, must also be taken into account.

As a rule, an external appraiser should be consulted for the valuation and the determination of the fair value. While not a silver bullet and coming with additional costs, in our experience it is one of the most effective means of preventing (or at least preparing for) later discussions with the tax authorities and protecting against additional tax burdens.

Does an Initial Dry Income Taxation "Infect" Later Proceeds? Luckily, the answer is usually "no". The German Federal Fiscal Court (*Bundesfinanzhof*—"**BFH**") (decisions of December 14, 2023, VI R 1/21 and VI R 2/21) recently clarified that even if the original participation was granted at a discount (and such non-cash benefit was subject to wage tax), later proceeds from a market standard sale of this participation do not constitute employment but capital income, which is subject to a typically more favorable income taxation. This has resolved a long-debated question in practice.

Two Ways to Address the Issue: If the start-up already has a certain value and the beneficiary is to receive real shares to enable a preferable future taxation compared to a VSOP, there are two ways to address the above-mentioned problem of dry income.

- By structuring so-called **growth shares (a.k.a hurdle shares)** as real shares with a negative liquidation preference, the fair value of the growth shares can be reduced to a level that is financially manageable for the beneficiary. If the beneficiary acquires growth shares at their fair value, no discount is granted and no dry income arises.
- Under the conditions of **sec. 19a EStG**, the wage tax on the amount of dry income at the time of share grant is initially deferred and only becomes due later (particularly in the event of the sale of the relevant shares in an exit). The dry income taxation is thus accepted, but it only becomes due at a time when the beneficiary also has liquidity available to cover the tax liability. However, it should be noted that under certain circumstances, a (possibly reduced) tax liability may still arise even if no liquidity flows to the beneficiary at that moment (this can especially be the case if the beneficiary leaves the company before the exit and the parties have not made any special arrangements for this scenario).

In the remainder of this Chapter, we will introduce the growth shares and shares making use of the tax deferral *per se*c. 19a EStG in more detail. For ease of reference, we will only speak of "**sec. 19a shares**" and "**sec. 19a instruments**" (the latter comprising the sec. 19a shares and the PPRs) but drop the "**EStG**".

Want to Know More About Growth and Hurdle Shares? With our Guide **OLNS#14**[1], we have dedicated an entire edition of the OLNS to the topic of growth shares, *i.e.*, when they are the best alternative, how they should best be structured and what practical pitfalls need to be avoided. **OLNS#14** also provides the results of an empirical study of almost 70 growth share programs on the stage of the company when growth shares are issued, how many growth shares are issued and to whom and what the amount of the hurdle is.

2.1.2 Alternative #1 – Reducing the Fair Value With Growth Shares

What Are Growth Shares? The issuance of straight equity/real shares to beneficiaries causes tax problems if the beneficiary does not pay the fair value for such shares, which is usually (much) higher than their nominal value. So, the question arises if anything can be done to lower the fair value of the shares to be issued to a beneficiary so that the upfront investment amount is limited but the beneficiary can still generate capital income in the future which benefits from the preferable income taxation of capital income. The answer is "yes", or to be more precise—as befits a lawyer—"yes, but...".

In a nutshell, the goal of growth shares is to reduce the fair value of the real shares to be acquired by the beneficiaries.

Growth shares are a special class of shares designed to incentivize key employees, managers or late co-founders—especially when the company's existing equity value is already high(er) and traditional share grants would be too expensive or tax-inefficient.

1. See OLNS#14—Growth and Hurdle Shares in German Start-ups, the Guide can be downloaded here: https://www.orrick.com/en/Insights/2025/03/Orrick-Legal-Ninja-Series-OLNS-14-Growth-and-Hurdle-Shares-in-German-Start-ups.

Growth shares are also known as hurdle shares, zero shares, NLP shares (negative liquidation preference shares), MIP shares (management incentive program shares), value shares or, occasionally, flowering shares. All these terms refer to shares that only participate in the increase in company value above a certain threshold. The latter is usually referred to as "hurdle" and is the central feature of growth shares. The hurdle is often the (pro-rated) company's current valuation at the time of grant and acts as a "negative liquidation preference". Growth shares only entitle their holders to proceeds (from a sale, distribution or liquidation) that exceed this hurdle. For example, if the hurdle is set at EUR 50 million and the company is sold for EUR 110 million, a beneficiary who holds 5% in the company as growth shares would receive 5% of the EUR 60 million in value created above the hurdle.

Since with growth shares the beneficiaries participate only in the further growth in value of the start-up but not the value that has been created so far and that is expressed in the hurdle amount, a lower fair value is regularly applied to growth shares compared to the fair value of the start-up's common shares or even preferred shares.

Apart from the negative liquidation preference, the growth shares are in general common shares. For tax reasons, we think that they should generally have the same rights as "normal" common shares, notably come with voting rights such as common shares (however, in our empirical survey published in OLNS#14, we found that in approx. 15% of the cases, the start-up issued growth shares as nonvoting shares).

The crucial question for the avoidance of dry income is therefore the fair value of the growth shares when taking into account the negative liquidation preference. The lower the fair value, the lower the acquisition price to be paid by the beneficiary in order to avoid dry income, respectively, the lower the incurred wage tax on the non-cash-benefit in case of acquisition at a discount. For a detailed discussion of this difficult question and how it is approached in practice, we refer you to OLNS#14.

How Do Growth Shares Get Taxed? There are two relevant points in time for the taxation of growth shares:

- the acquisition of the growth shares, and
- the sale of the growth shares.

During the holding period, no income is typically realized due to the lack of distributions by the start-up. Growth shares avoid taxation at the time of the transfer to a beneficiary (assuming they are issued at fair value).

The taxation at the time of the sale of the growth shares by a beneficiary (or a comparable trigger event), provided that beneficial ownership has also been transferred initially, depends on whether or not the beneficiary has held the growth shares through a personal holding entity in the legal form of a corporation:

- If the beneficiary holds the growth shares directly: Capital gains taxation on the spread between the sale proceeds above the hurdle and the tax costs of the beneficiary for the acquisition of the growth shares at an aggregated max. **(i) 28.485%** (income tax (*Einkommensteuer*) including solidarity surcharge plus church tax, if applicable) if the beneficiary holds/has held at least 1% equity participation (directly or indirectly) in the start-up within the last five years; or **(ii) 26.375%** (income tax including solidarity surcharge plus church tax if applicable) in all other cases provided that the beneficiary does not hold the growth shares as business assets.
- If the beneficiary holds the growth shares indirectly through a personal holding entity: Capital gains taxation on the spread between the sale proceeds above the hurdle and the tax costs of the personal holding entity for the acquisition of the growth shares whereby tax exemptions may apply resulting in an aggregate tax burden of approx. **1.5%** (corporate income tax (*Körperschaftsteuer*), trade tax (*Gewerbesteuer*) and solidarity surcharge). Please note that dividends may be taxed at relevantly higher rates and holding growth shares via a personal holding entity might not be the best structure if the start-up is more of a "dividend case" rather than an "exit case".

Obviously, the income generated from growth shares is taxed much more favorably compared to the tax treatment of current income in case of proceeds from VSOPs, which are fully subject to wage tax at the personal tax rate (*i.e.*, under certain circumstances up to 47.475% including solidarity surcharge plus church tax if applicable). When held through personal holding entities, the tax rate applicable on capital gains from the sale of growth shares is also significantly lower than the one for sec. 19a shares, which can only be held directly.

What Are the Disadvantages of Growth Shares? The issuance of growth shares usually requires a significantly higher structuring effort. The various stakeholders must be familiar with the instrument, and special rules have to be included in the shareholders' agreement and the start-up's articles of association.

Growth shares must be acquired at their fair value and the valuation of these special shares is also regularly more complex and time-consuming (we discuss details and the need for external appraisals in OLNS#14). Finally, special share classes are more susceptible to audits, and additional costs can also arise in external audits. In addition, growth shares are real shares and come with the governance issues described below.

In sum, growth shares can be the most tax-efficient ESOP structure available, but as we will see, they don't scale very well beyond a handful of beneficiaries or require significant organizational efforts.

2.1.3 Alternative #2 – Accept but Defer With Sec. 19a Shares

What Are Sec. 19a Shares? If issuing growth shares is not feasible—or you simply want a more standardized, "government-backed" solution—sec. 19a EStG can offer a (more or less) pragmatic way forward. Sec. 19a instruments typically mean "real" shares or certain PPRs that are granted to employees of qualifying start-ups (*i.e.*, young and still an SME, see below). Instead of fighting the dry income problem head-on, this approach accepts that wage tax on a discounted Award will arise but defers the tax to a moment when employees (hopefully) have the liquidity to pay it. For ease of reference we will for now talk about "sec. 19a shares" and discuss the particularities of PPRs further below. However, the prerequisites for sec. 19a EStG discussed in this Chapter apply equally to shares as well as PPRs.

> In short, sec. 19a shares let employees in eligible companies get real shares or profit participations with delayed tax payments, so they don't get taxed for the value immediately upon receiving them but later when they can actually benefit financially.

The sec. 19a shares must be granted in addition to the remuneration owed to the employee; and the acquiror of the sec. 19a shares must be an employee of the company that issues the sec. 19a shares or of its subsidiary (the latter is the so-called "group privilege", see below).

The prerequisite for the application of the tax deferral provision of sec. 19a EStG is, that the start-up must have met the following thresholds once in the current or the preceding six years:

- upon issuance of the sec. 19a shares, the company must not be older than 20 years; and
- the start-up must be a small or medium-sized enterprise ("SME"), *i.e.*,
- less than 1,000 employees and less than EUR 100 million annual turnover; or
- less than 1,000 employees and max. EUR 86 million balance sheet sum.

Fun fact (or maybe not so fun for scale-ups): The employee, revenue and balance sheet thresholds set for sec. 19a EStG actually trace back to an EU Commission "recommendation" from 2003. Yeah, that's right… 2003… The goal back then was to standardize what counts as a SME across the EEA. To be honest, the 1,000-employee threshold isn't the real bottleneck here—most start-ups, even ambitious ones, aren't blowing past 250 employees anytime soon, let alone 1,000. But the financial thresholds? Those are real relics. Despite nearly 62% total EUR inflation since 2003, the EUR 86 million balance sheet limit hasn't changed.

Fast forward more than two decades, and these financial thresholds look increasingly like a museum piece. In today's start-up and VC landscape, reaching a balance sheet total of EUR 86 million is hardly rare—many companies can hit that just by closing a couple of solid funding rounds. The result? You might still be operating like a scrappy young start-up, but the law won't see you as an SME anymore—and that means you lose access to sec. 19a EStG benefits relatively soon, even though you're anything but a corporate giant. If there was ever a part of this law overdue for a reality check, it is this one.

The current version of sec. 19a EStG also grants the advantage of the so-called "**group privilege**", meaning it is also available for shares that are not issued by the company that employs the beneficiary but also for shares issued by another group entity. But surprise, surprise: for the group privilege to apply, the aforementioned restrictions need to be fulfilled by the whole group (all of its entities combined), not just the company issuing the shares. The legislator considers these limitations necessary to prevent unintended tax benefits for employees of large corporations by shifting business units into smaller subsidiaries and then granting parent company shares under favorable tax treatment. In practice, this means that even if only one group company exceeds the SME thresholds or maximum age, the entire group is excluded from the privilege. As a result, the group clause can significantly curtail the applicability of sec. 19aEStG, particularly for scale-ups or companies with a more complex group structure. We know what you are thinking now, because we are thinking the same…

There is also some uncertainty around the group privilege, in particular whether the group privilege requires the company that issues the sec. 19a shares to be a German entity or at least an EU entity or whether, for example, the tax deferral would be available for the employees of a German subsidiary for which its U.S. mother company has set up a "Silicon Valley-style" ESOP with restricted stock units (see also below under Chapter A.V.3.2.).

Oh, thanks for asking, our answer is a resounding "yes", at least if the U.S. entity that issues the sec. 19a shares to the employees of its German subsidiary is a corporation (Inc.). However, until the German tax authorities provide official clarification or case law emerges, companies need to be aware of these uncertainties.

When and How Do Sec. 19a Shares Get Taxed? With sec. 19a shares, the dry income problem isn't eliminated—but it is postponed. Taxation is deferred until a true liquidity event occurs or to a point in time in the distant future, *i.e.*:

- the participation granted is transferred in whole or in part for a consideration or free of charge, or is contributed to a corporation in a concealed manner;
- fifteen years have passed since the acquisition of the shares; or
- the employment with the employer who (directly or through its controlling companies) granted the shares to the employee is terminated. If the employer (which they can do) "guarantees" payment of the wage tax in this case, the deduction amount taken over is not part of the taxable salary.

The idea is that wage tax is only levied when the beneficiary has actually received liquid assets. At that time in the future, wage tax is then due on the non-cash benefit (the difference between the value of the sec. 19a shares at the time of acquisition and the purchase price paid for them, the latter usually not more than the nominal value of the shares, provided that, as we will see according to some authorities, PPRs require some (minor) investment beyond the nominal value). The increase in value since the acquisition is subject to the more favorable capital income taxation.

If things do not develop as expected and the fair value of the sec. 19a shares (or PPRs) falls below the fair value determined at the time of grant (*i.e.*, the basis for the deferred wage tax), the lower fair value at the end of the deferral period will be used to determine the taxable non-cash benefit. Consequently, a buyback of sec. 19a instruments by the employer or its shareholders will only result in wage tax liability if the buyback price exceeds the amount of the original acquisition costs of the employee.

While the law still provides that wage tax deferral ends in certain circumstances even if no liquidity is received—such as the lapse of 15 years after receipt of the sec. 19a instruments or upon termination of the underlying employment—the tax deferral may be extended until a sale of the sec. 19a instruments, provided the employer irrevocably undertakes to assume liability for the wage tax arising upon such sale.

It is important to note that social security contributions are not considered taxes. Any social security contributions on the non-cash benefit arising from sec. 19a instruments must be paid by the company when the beneficiary receives the sec. 19a instrument, even if no liquidity is provided and regardless of whether wage tax is deferred under sec. 19a EStG. No additional social security contributions will become due upon a subsequent sale of the sec. 19a instruments.

What Are the Disadvantages of Sec. 19a Shares? Long story short: Sec. 19a EStG is far from perfect. As always, there are trade-offs. In practice, sec. 19a EStG aims to make equity more accessible for rank-and-file employees in Germany but in the end, it still remains a compromise. One challenge is the administrative complexity. Sec. 19a EStG does not relieve the company of the burden of determining the fair value of the sec. 19a shares at the time of grant (see A.III.2.1.1.). If the fair value of the sec.19a shares can be established from arm's-length transactions within the past year, this value may be used. If no suitable transaction exists, a valuation report should be prepared applying investor-standard valuation methods accepted for growth companies (with the net asset value as floor). As a rule, the fair value applied should be confirmed by the competent tax office through a wage tax ruling (*Lohnsteueranrufungsauskunft*) obtained after the grant of the sec. 19a shares. Furthermore, the company still needs to monitor the eligibility criteria, keep an eye on employment changes and make sure everyone, in particular the beneficiaries, is clear about when tax will eventually be due.

For employees, there is always the risk that an unexpected tax event—such as leaving the company or a corporate restructuring—may trigger taxation at an inopportune time, potentially without sufficient liquidity to cover the tax bill. The end of the deferral of taxation when the employment relationship with the start-up is terminated or after the expiry of 15 calendar years is criticized because a change of employer, which triggers taxation, does not bring liquid assets and could thus make resignations more difficult. For the same reason (lack of liquid assets), the expiration of the tax deferral after 15 calendar years was criticized by many in the ecosystem. The legislator responded by allowing an additional tax deferral until the sale of the shares, provided that the employer assumes liability for the wage tax becoming due at that time.

"We see increasing interest in sec. 19a even amongst Pre-Seed and Seed stage companies. We're not there yet, but if the tax offices continue to be receptive, sec. 19a may become a success story and give a real boost to the German start-up scene."

Tilman Langer, General Counsel at Point Nine Capital

In addition to these tax-related weaknesses, at least when real shares are issued, this comes with some serious governance issues. Spoiler, to mitigate these governance issues but still stay within the requirements of sec. 19aEStG PPRs have been proposed (see below).

2.2 Governance Issues and Cost Implications

Let us leave potential tax issues and their remedies aside for a moment and look at other challenges that might come with ESOPs that are based on issuing shares to the beneficiaries.

There are two structuring alternatives for the issuance of shares:

- direct issuance/transfer of shares to the beneficiaries; and
- indirect issuance/transfer of shares to the beneficiaries who are pooled in a ManCo.

Both alternatives come with their own governance and cost challenges.

2.2.1 Direct Issuances

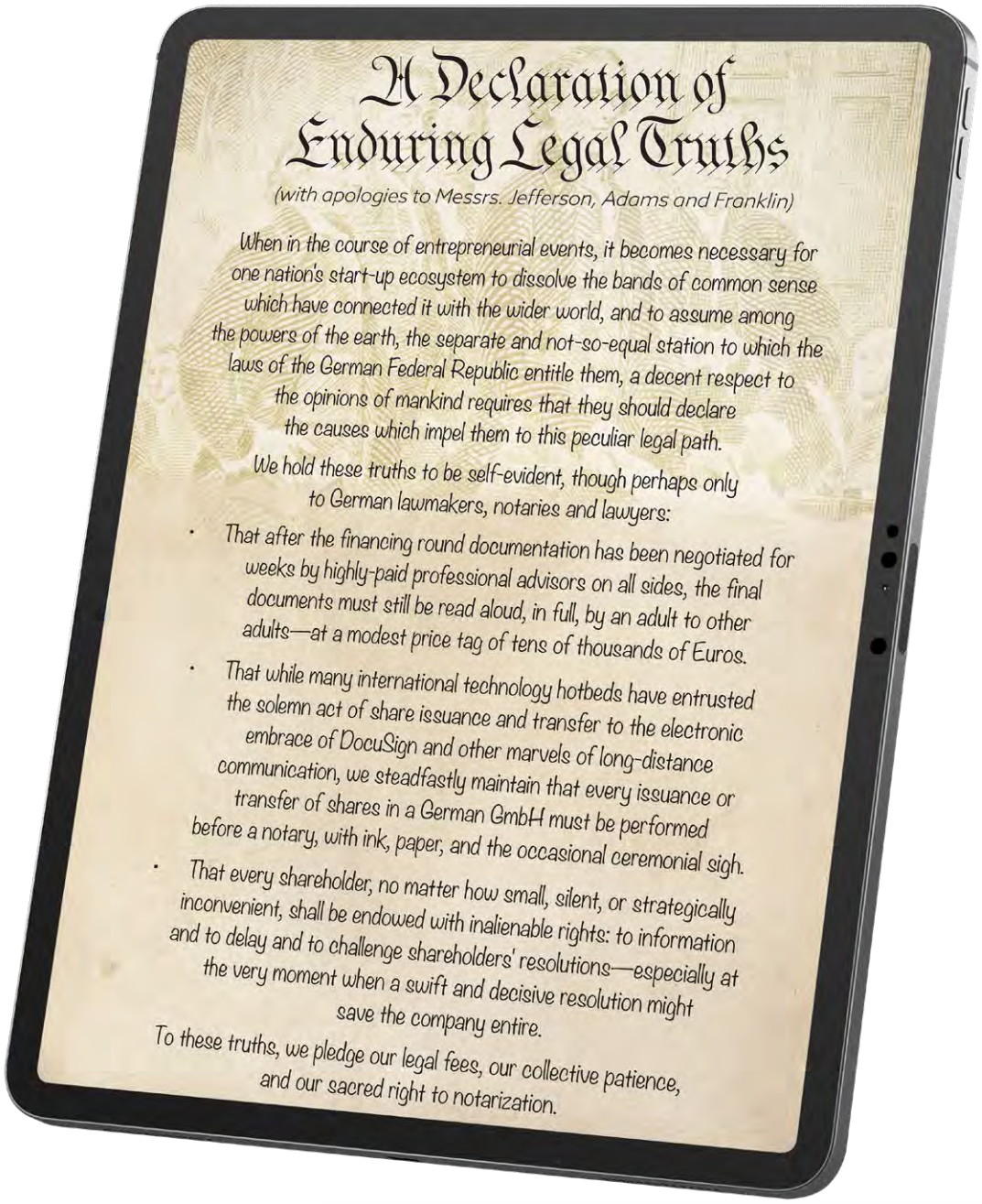
Let's be honest: In theory, giving employees shares in a German start-up might sound like the ultimate motivational tool, but in practice, it's a governance headache waiting to happen. To set it straight: the idea of Employee Ownership programs in a start-up is not to give the beneficiaries a say in the company's governance but to exclusively give them a stake in the value they help to create. The goal is a mere economic incentive, not to transfer any control or participation rights. Here, real share ownership for employees (including option programs that can actually result in the beneficiary acquiring shares at some point in the future) can be problematic for a number of reasons (the following Chapters apply to option models only insofar as they could ultimately result in a beneficiary holding shares in the company and will not be settled in cash only).

Certain Unalienable Rights: Every new shareholder—no matter how tiny their stake—gets a bundle of statutory rights. These include for example a broad access to company information (hello, sec. 51a German Act on Limited Liability Companies) to voting at shareholders' meetings and the right to challenge shareholder resolutions. If you're running a lean start-up, that can mean a lot of extra work just to get simple decisions made and can turn simple decisions into slow-motion drama.

Impact on Decision-making Processes: In a start-up, it is sometimes necessary to quickly obtain shareholders' approval for certain actions, measures or the issuance of new shares. Here, it is a great advantage if the cap table is small and all shareholders are willing to waive formal requirements regarding the convocation, preparation and conduct of a shareholders' meeting and adopt decisions quickly. While there are certain options for the adoption of written shareholders' resolutions outside of shareholders' meetings that require the participation of only a qualified majority of votes, the most agile decision-making process still requires the participation of all shareholders.

Financing Round Documentation: It gets even more complex in the VC world. Every new shareholder needs to sign up to the investment and shareholders' agreements, and with each financing round, that's another negotiation, another signature and another layer of coordination. The process can quickly become unwieldy, especially as the company grows and the number of employee shareholders increases. So, the more shareholders on the cap table the merrier the negotiations and the signing process. Believe us, most of the authors of this Guide at some point had second thoughts about their career choices when trying to obtain written or—even funnier—certified (in notarized form) and apostilled powers of attorney from 40+ shareholders around the world while the start-up is running low on cash and the incoming U.S. investors still try to get their heads around why the Germans are still not on *DocuSign*.

Administrative Burdens and Notarization Requirement: Unless the company holds treasury shares, it will need to create new shares to grant them to the respective beneficiaries. The issue of new shares generally requires a notarized capital increase, the payment of the nominal amounts and the entry of the capital increase in the commercial register. This is a process that often takes several weeks and involves considerable costs and administrative effort (though with an authorized capital (*genehmigtes Kapital*), some of the administrative burden can be eased). The transfer of existing shares must also be notarized. In each case, an amended list of shareholders must be filed with the commercial register. The notarization requirement alone makes incentive schemes that are based on a direct shareholding in the start-up unscalable. Even if the start-up "only" wants to issue options on "real" shares, it must either contractually obligate all shareholders to fulfill the option rights or have a so-called authorized capital created within the framework of a shareholders' meeting, which must be notarized, in order to be able to fulfill the option rights at the appropriate time. It should be noted that, due to mandatory legal requirements, authorized capital can currently only be created for a maximum of five years at a time and cannot exceed half of the registered capital.



To wrap it up: The more fragmented your cap table, the harder it gets to move fast—which, in a market defined by speed and competition, is hardly what you want. These issues are specific to the direct issuances of shares and come on top of the transaction costs (legal documentation and notarization fees as well as court fees) required for the documentation of any transfer of shares (be it to the beneficiary or his holding entity) directly or to a ManCo.

That's why, in practice, direct issuances of growth shares or sec. 19a shares are almost always limited to a very small group—typically three to five key people. Once you go beyond that, it's time for an arguably smarter workaround: the ManCo.

2.2.2 The Use of ManCos – Higher Costs but Simpler Governance

ManCos are often set up as a GmbH & Co. KG (*i.e.*, a limited liability partnership under German law with a GmbH as its general partner). Additionally, in order to avoid trade tax liability, ManCos need to have one managing limited partner, which should be set up as a GmbH (*Entprägung*). The ManCo then qualifies as a non-commercial partnership (*vermögensverwaltende Kommanditgesellschaft*) for German tax purposes. The general partner and the managing limited partners can be wholly owned by a designated founder or investor who is subject to instructions of the relevant majority as per the shareholders' agreement.

The beneficiaries will become limited partners of the ManCo and hold their limited partnership interest directly (only option if the ManCo is meant to hold sec. 19a shares) or directly or indirectly through their own holding entities (both options are available if the ManCo is meant to hold growth shares). Consequently, beneficiaries receive, purchase, or sell partnership interests rather than shares, while being taxed as if they were direct shareholders.

The beauty of this structure is the following: the beneficiaries do not become direct shareholders in the start-up. Rather, shareholder rights vested in the shares are exercised by ManCo and subject to the latter's corporate governance (as the general partner and the managing limited partner are controlled by the founders or investors, respectively, the risk of the beneficiaries to obstruct or create nuisance is largely eliminated). The transfer of the limited partnership interest in ManCo is subject to less formalities than the transfer of shares in a GmbH (*e.g.*, no notarization).

With a ManCo, decisions stay reasonably fast and friction-free, even as more employees join the pool. And because the ManCo is set up as a non-commercial partnership, it also steers clear of unwanted trade tax liability.

Of course, this structure doesn't come for free: you'll need to set up and maintain the ManCo, fund its ongoing administration, and think carefully about tax and corporate law implications—especially when it comes to where the shares held by the ManCo actually come from. Furthermore, despite the general availability of sec. 19a EStG benefits for ManCo-held shares, the law creates operational difficulties. Sec. 19a EStG requires that the beneficiaries acquire shares directly from their employer or from a shareholder of their employer, excluding acquisition through other group entities or warehouse companies that lack direct shareholding in the employer; the market is currently testing alternative approaches (including the use of trustee arrangements as warehouse solutions). Additionally, the share pool distributed through a ManCo should be limited to a specific size from the beginning.

Subsequent expansions of the share pool held through the same ManCo should be avoided to prevent adverse tax consequences from unintended taxable gain realization. Instead, a separate ManCo structure should be established for any new employee participation scheme. But as a solution for scaling Employee Ownership without letting governance spiral out of control, we see ManCo models deployed in early-stage growth companies as they in particular better allow to scale the issuance of growth shares compared to direct issuances.

2.3 Can Stock Options Help?

After we discussed the tax and governance issues with granting real shares, let us briefly look at the question whether these issues can be avoided or at least mitigated by structuring Awards as an option for shares. If the beneficiary is granted stock options within the framework of an employment relationship instead of shares, the granting of the stock options gives the beneficiary the right to acquire shares in the company of the option provider at a certain price (the strike price). This right can be exercised by the beneficiary at a later date and the shares can thus be obtained at a reduced price under certain circumstances.

Regarding the tax consequences of stock options, a distinction must be made between several points in time, *i.e.*, the time of

- granting of the stock option;
- the first exercisability of the stock option (vesting);
- exercise of the stock option;
- sale of shares received;
- alternatively: the sale of the stock option;
- alternatively: the stock option being otherwise realized, *e.g.*, by transfer of the stock option to a personal entity corporation; and
- expiry of the stock options.

Granting of the Stock Option: The granting of stock options usually does not trigger tax liabilities in Germany. Jurisprudence, tax administration and tax law literature are nowadays in agreement that the granting of the stock option itself does not constitute a tax-relevant transaction. From a tax perspective, beneficiaries merely acquire an opportunity to "purchase" shares in the company at a later date at more favorable conditions and thereby become "real" shareholders. This does not constitute an "inflow" of non-cash remuneration.

Time of First Exercisability (Vesting): As a rule, Employee Ownership programs contain so-called vesting rules (for details on vesting schemes, see Chapter A.IV.3.). Vesting (stock options become exercisable over time while—apart from acceleration events—non-vested stock options are not exercisable) does not trigger taxation under German tax law.

Exercise of the Stock Option: Only when exercising the stock option (the "exercise") and acquiring shares in the company at a reduced price do the employee beneficiaries regularly earn income (subject to wage taxation). The rules for the valuation of the shares and for taxation as described for the acquisition of real shares apply here to a large extent as well, so that we refer to the explanations above.

It is particularly important to note that the non-cash benefit accruing to an employee under an ESOP is only determined at the time of exercising the option/ acquiring the shares, as the amount of the non-cash benefit depends decisively on the fair value of the shares underlying the ESOP at that (later) point in time. The non-cash benefit is then determined by deducting the strike price payable by the employee (and any other costs to be borne by them) from the fair value of the shares. The non-cash benefit is subject to income tax (regularly: wage tax). Therefore, the time at which stock options are being granted is in principle—unlike the time of granting/ issuance of "real" shares—neither relevant for the time of accrual of the tax nor for the assessment basis of the tax. Obviously, this can result in considerable differences for taxation purposes.

Since the tax accrual is linked to the granting of shares, dry income arises, *i.e.*, a tax without an inflow of liquidity, if the employee cannot immediately transfer the shares against payment. Incidentally, besides the governance issues associated with having a lot of parties in the cap table, this is the main reason why claims from stock option programs in Germany are regularly only exercised at the time of an exit or at the earliest when investors provide liquidity for the tax accrual.

While options, once exercised, will not help with the governance issues, it should be noted that if the prerequisites of sec. 19a EStG are met, the tax liability can be deferred and for the incremental value after the exercise, the beneficiary can benefit from the lower capital gain taxation. However, given that the value of the underlying shares in the start-up will (hopefully) rise during the time of vesting, the beneficiary will generally fare better from a tax perspective the earlier the beneficiary acquires the share or (as we will discuss below) the PPRs. This is because a lower portion of the overall exit consideration attributable to the sec. 19a instrument will be subject to the higher wage taxation.

Sale of the Shares Received: If the beneficiary has become the beneficial owner of the shares after exercising the stock option, a gain from the subsequent sale of the shares should regularly lead to capital income for the beneficiary, which is taxable at a maximum starting rate of 26.375% (plus church tax, if applicable), provided that the beneficiary has not held an interest in the start-up at all or has consistently held an interest of less than 1% in the last five years and has held the interest as private assets. In cases where the beneficiary has exceeded or is exceeding this threshold, the maximum tax burden on the disposal of the participation held as private assets is 28.485% (plus church tax, if applicable) with regard to the capital gain. In the event of a sale of an employee shareholding from the employee's business assets—which will in fact only occur very rarely—the employee must also pay trade tax.

Sale of the Stock Option: Rarely, the beneficiary is also granted the alternative that they may sell the stock option themselves without having previously acquired the share in the company. According to the case law of the BFH, the realization of the option right through a sale leads to the accrual of tax. The purchase price is considered to be income from employment.

"Other Realization": The authorities will also seek to collect taxes in cases of so-called "other realization" of the stock option. "Other realization" can occur, among other things, if the beneficiary transfers the option to their personal holding company before exercising it or waives their option right against payment.

This offers potential for structuring Employee Ownership. In individual cases, it may be worthwhile to generate a pecuniary advantage as early as possible by contributing the stock options to a personal holding corporation and triggering taxation. The price, however, is a tax on dry income because there is no cash inflow at this point. The effects must be weighed carefully here: If the stock option is realized otherwise, it must be valued, which will cause additional expense.

Expiry of the Stock Option: If the beneficiary allows the option to expire instead of exercising it or if it expires because, for example, the employment relationship is terminated prematurely (no vesting), no tax accrues. The renunciation against payment, on the other hand, triggers a tax liability with regard to the payment.

2.4 Profit Participation Rights – The Best of Both Worlds?

Let us now explore a new option in the Employee Ownership toolbox that promises the relatively attractive sec. 19a EStG taxation without the governance complexities described above. Enter PPRs.

PPRs haven't yet become the first choice for incentivizing employees in exit-driven German start-ups, but they're increasingly considered as an alternative—especially by founders seeking to combine administrative simplicity with tax efficiency. While VSOPs still dominate the landscape, PPRs offer more favorable employee taxation compared to VSOPs, without the governance challenges and formal requirements typically associated with equity-based programs. However, as we'll see, when something seems too good to be true… well, trust your instincts. PPRs come with their own practical challenges.

> **What Are PPRs?** PPRs are highly flexible financial instruments under German law, benefiting from the absence of detailed statutory regulation. Legally, a PPR is a contractual claim held by a non-shareholder, typically requiring some form of investment in or payment to the company for recognition under German law. Due to broad contractual freedom, PPR agreements can be tailored to specific company and employee needs, granting holders financial rights normally reserved for shareholders—such as profit sharing, liquidation proceeds participation and crucially for Employee Ownership contexts, a share in future exit proceeds—without issuing actual shares.

A genuine PPR always involves company profit participation (sometimes losses and liquidation proceeds too) and importantly includes participation in exit proceeds as a shareholder, but never grants control, voting or management rights. PPR holders also lack challenge rights against shareholder resolutions. Without profit linkage, it's not a true PPR under German law, and typically some investment or payment to the start-up is required for legal recognition (we will discuss the required investment further below).

When comparing PPRs and VSOPs as tools for employee incentivization, both instruments share some similarities: they enable employees to participate in the company's financial upside—typically in the event of an exit—while not granting actual shareholder rights. In a VSOP, beneficiaries have a contractual right to a cash payment in connection with a specified liquidity event, as outlined in the VSOP plan. By contrast, the economic rights under a PPR are typically structured to mirror those of common shareholders, so that beneficiaries are entitled to (nearly) the same financial rewards as founders. In the event of an exit, this may involve the PPRs—like in case of actual sec. 19a shares—being sold together with the founders' shares, thus ensuring the beneficiary's participation in the exit proceeds.

Alternatively, the PPR may entitle the beneficiary to a payment upon an exit that places them in a financially equivalent position to a founder selling their shares. There is no established market standard yet, and it is still uncertain which structure will be more readily accepted by tax authorities.

Major Advantages of PPRs: Unlike actual shareholders, PPR holders receive no information, control or voting rights. This distinction enables companies to incentivize employees financially without diluting control or complicating governance by expanding the cap table to include numerous current or former employees.

Another key advantage is that PPRs, when structured under sec. 19a EStG, can avoid dry income taxation on any non-cash benefit resulting from the difference between the cash contribution (*Einlage*) made by the beneficiary and the fair value of the PPR at grant. Any payments to the beneficiary exceeding the fair value at grant are then subject to favorable capital gains taxation upon realization—even though no "real" shares are issued. This represents a significant benefit compared to VSOPs, which are taxed as regular income.

Finally, PPRs can generally be issued, transferred, re-acquired and terminated without notarization.

Requirements for PPR Recognition Under Sec. 19a EStG: Wage taxation on PPR grants is deferred under sec. 19a EStG when they're structured as described in this Chapter, ensuring they don't create partnership status (*Mitunternehmerschaft*—through management, voting, or meaningful control rights) under sec. 15 para. 1 no. 2 EStG but instead qualify as financial participations under sec. 19a EStG—provided no repayment at nominal value is stipulated. Naturally, all general requirements for sec. 19a EStG applicability (see Chapter A.III.2.1.3.) must also be met.

Be careful though: If PPRs are allocated to employees without any employee cash contribution—even partially free of charge—the entire PPR value is treated as taxable salary (*geldwerter Vorteil*) and becomes subject to wage tax. This is the standard approach of German tax authorities, especially when PPRs are issued as bonuses or on favorable terms (*e.g.*, at a discount). To prevent immediate and potentially significant wage taxation on the full grant value, market practice requires employees to make at least some economic contribution when receiving PPRs, representing their own risk stake (we will discuss details in a second). The beneficiary holds a repayment claim against the start-up for this contribution. However, this contribution isn't guaranteed to be recovered, particularly if the start-up ultimately fails or enters liquidation.

Challenge #1 – Determining the Initial Investment: The main question plaguing practitioners is: How much should the investment for PPRs be to ensure recognition as PPRs and thus qualify for sec. 19a EStG treatment?

There's no statutory minimum or official tax guidance setting a required percentage for employee PPRs. What matters is that the grant isn't entirely free or purely symbolic, but represents a meaningful, well-documented economic contribution.

Doesn't sound particularly clear-cut, right? Exactly.

There's no one-size-fits-all formula or statutory minimum for what employees should contribute as their "*skin in the game*". In practice, the initial investment amount is a matter of design and negotiation. It should be substantial enough to demonstrate to the tax office that there's a real economic stake, but not so high that it becomes a dealbreaker for employees. The company's valuation is often used as a reference point, and according to some practitioners and tax authorities, the beneficiary should invest in the range of 3-5% of the pro-rated company valuation represented by their Award. However, in our practice we have also seen cases where PPRs where issued at an acquisition price of EUR 1.00 and the competent tax authorities confirmed the applicability of sec. 19a EStG.

However, the "3-5% of fair market value" is at best a rule of thumb—just a practical convention to help demonstrate to the tax office that the employee's investment is genuine, not a disguised bonus. In practice, the investment can be more or less than this, as long as it is economically significant and properly documented. And don't forget: the employee actually has to provide the cash. For junior or mid-level staff, even a "modest" investment can be a hurdle, especially in cash-tight start-up environments. If the upfront contribution is too steep, you risk making the incentive inaccessible to the very people you want to motivate.

Given the legal uncertainty and potential tax stakes, best practice is obtaining a wage tax ruling from your local tax office before rolling out a PPR-based Employee Ownership program. This provides much-needed planning security and ensures your structure is recognized as falling under sec. 19a EStG—before any real money changes hands. For companies, it means (somewhat) more administration, more documentation and (at least initially) more explaining as in case of sec. 19a shares.

Challenge #2 – Determining the PPR Value for Tax Purposes: Sec. 19a EStG may promise tax deferral, but raises the question how to put a reliable price tag on PPRs at grant, so you know what wage tax will eventually be due. As employees holding PPRs are intended to be placed in a similar position as holders of common shares, the determination of the fair value of such PPRs at the time of grant should follow the same criteria, based on sec. 11 para. 2 BewG, as those used to determine the fair value of real shares at grant (see A.III.2.1.1.). If there's a recent financing round with third-party sales, there's a market value to work with. If not, a valuation is required, applying investor-standard methods as accepted for share valuations of growth companies. As there are still few practical precedents, it is for the time being best practice not to forego obtaining an additional wage tax ruling from your local tax office after the grant of the PPRs, confirming the PPR's fair value at grant (as it is often (still) advisable in case of sec. 19a shares). Consequently, a least until market practices have been established and been blessed by the tax authorities, two separate rounds of consultations with the tax authorities are advisable: one prior to issuance of the PPRs to confirm that the PPRs qualify as PPRs for tax purposes (thereby making them eligible for tax deferral under sec. 19a EStG), and another following the issuance of the PPRs to validate their fair value. Add in the fact that social security contributions are due at grant (remember: not deferrable, however, only applicable to the extent that the payment limits have not already been reached in the relevant calendar year) and you've got a plan that's only as simple as your last spreadsheet update.

Challenge #3 – No International Playbook: PPRs are relatively new in the German Employee Ownership toolbox and internationally this concept is relatively unknown. The German-style PPR with sec. 19a EStG tax deferral is a homegrown solution. Most international start-up hubs rely on classic stock options, restricted stock units or phantom plans—where the rules, tax consequences and expectations are clear and market practices have developed over decades. That means international hires, global investors and even your own co-founders may need a crash course in what PPRs actually are, what rights they do (and don't) provide and what the real-world trade-offs look like. Expect questions. Expect skepticism. And be ready to do some education—because outside the DACH bubble, "*Genussrechte*" might still be lost in translation.

2.5 Summary

To wrap up this overview Chapter, the following graphic summarizes some of the material considerations when making a choice between VSOPs and ESOPs as well as the respective sub-categories of ESOPs:

GROWTH SHARES AND SEC. 19A ESTG INSTRUMENTS

	Growth Shares	Sec. 19a EStG Instruments	VSOP
Potential Beneficiaries	No restrictions.	Only for employees of the company or its subsidiaries and only if the issuing company fulfils the requirements of sec. 19a EStG. Profit Participation Rights: Issuance to foreign employees should be assessed with local counsel prior to issuance.	No restrictions.
Scalability	Limited. If there are more than a few beneficiaries, often a ManCo will be required. However, issuance of growth shares should always be made in close timely proximity with an external appraisal of the issuer.	**Real Shares:** Limited. If there are more than a few beneficiaries, often a ManCo will be required. **Profit Participation Rights:** Improved scalability as beneficiaries have no shareholder rights (no voting, control, objection or information rights). However, issuance of profit participation rights should always be made in close timely proximity with an external appraisal of the issuer.	As there are still a number of open practical items regarding profit participation rights which make them slower to implement and more costly, VSOPs still appear to be the "easiest" instrument to implement to scale in practice (however, with the tax disadvantages attached as described below).
Appraisal Advisable?	Yes.	Yes.	No.
Investment Required?	To avoid wage tax risks, the growth shares need to be acquired at their fair value (which is likely low due to the applicable hurdle).	**Real Shares:** No investment required. Wage tax is levied on the difference between the purchase price and the fair value of the real shares at the time of issuance, and its payment can be deferred until a liquidity event occurs. **Profit Participation Rights:** In line with the participation of a common shareholder (typically the founders), a contribution must be made upon issuance of the profit participation right by the company which can generally emulate the nominal value of a common share of the issuer with corresponding economic *pro rata* rights (*i.e.*, usually EUR 1 per profit participation right with same financial rights as a common share with a EUR 1 nominal amount). However, the tax authorities' view is still inconsistent, and it cannot be ruled out that some individual tax offices may require a higher investment amount for the profit participation rights to qualify for the purposes of sec. 19a EStG.	Not required.

	Growth Shares	Sec. 19a EStG Instruments	VSOP
Form Requirements	Issuance and (re-) transfers require involvement of notaries.	**Real Shares:** Same as for growth shares. **Profit Participation Rights:** No form requirements, in particular text form is available (pdf, electronic signatures, *etc.*); *i.e.*, program should be implemented at least in text form.	No form requirements, in particular text form is available (pdf, electronic signatures, *etc.*). To ensure proper documentation, the entire program should be set up and administered in text form.
Corporate Governance	Holders of growth shares have certain unalienable shareholders' rights and for practical purposes need to execute investment and shareholders' agreements.	**Real Shares:** Same as for growth shares. **Profit Participation Rights:** No (less) issues. • Profit participation rights need to come with certain rights/obligations but usual shareholders' rights will be excluded (no voting, control, objection or information rights). • The profit participation right participates *pro rata* (on the same level as common shares) in any dividend distributions during its term (if applicable).	No governance issues, since VSOP only grants the beneficiaries payment claims against the issuing company (no shareholder rights). VSOP usually does not participate in dividend distributions.
Dry Income Risks	Low, if granted at their fair value but there might be uncertainty on how to determine the fair value.	Generally no since the taxation of the non-cash benefit is deferred but there might be uncertainty on how to determine the non-cash benefit.	No.
Tax Advantages	No wage tax on acquisition of growth shares and if held through a personal holding entity, the tax rate applicable to later proceeds can be reduced to c. 1.5%.	Deferred wage tax (up to approx. 47.5% plus church tax if applicable) on the non-cash benefit granted upon acquisition of the sec. 19a EStG instrument until occurrence of a liquidity event taxation as capital income on incremental value. However, tax rate cannot be reduced below c. 28.5% or c. 26.4% (depending on the size of the beneficiary's current or past shareholding, plus church tax if applicable) as sec. 19a EStG instruments cannot be held by beneficiaries through a personal holding entity.	No tax advantages, any proceeds are subject to wage tax (up to approx. 47.5% plus church tax if applicable).
Involvement of Tax Authorities Upon Grant	Recommended.	Recommended.	Not required.
Overall Complexity and Costs	Medium.	Arguably low(er), but currently there are still some open practical issues which require close coordination with competent tax authorities to avoid negative tax consequences. Market and tax authorities are still in the early-adoption and learning phases.	Low.

IV. Main Features of Employee Ownership Programs

In this Chapter, we want to present some common features and the commercial value drivers of Employee Ownership programs. These reflect general principles of employee incentivization and are similar in most incentive plans, irrespective of their (mostly tax- and governance-driven) structure and the type of benefits granted (ESOP vs. VSOP, *etc.*). Whenever specific aspects apply only to particular types of Employee Ownership programs, we will clearly identify these distinctions.

A note of caution before we get into the nuts and bolts of these programs: Founders and investors alike dilute their ownership in the company when they introduce Employee Ownership programs. That is only a worthwhile endeavor if the program can achieve its goals—hire, retain, motivate and align a winning team. Founders need to communicate the benefits of an Employee Ownership program constantly and clearly and should avoid lengthy and complex programs (we know… guilty as charged). But a program that is perceived as unfair, inconsistent, unreal or is simply not understood, will backfire while potentially still diluting the owners of the company.

"More traditional European lawyers and advisors often propose approaches and grants which are biased in favor of the employer, but we invite you to be more enlightened. In our experience, rewarding talent meaningfully and fairly is not only warm and fuzzy, it also makes business sense."

Index Ventures, Rewarding Talent

1. THE LEGAL DOCUMENTATION

The legal documentation of Employee Ownership programs forms the foundation that determines whether a carefully crafted incentive scheme will achieve its intended goals or become a source of confusion, disputes and potential legal challenges. This Chapter examines the essential structural and drafting considerations that can make or break a program's effectiveness. Understanding these documentation fundamentals is essential before diving into the specific terms and provisions that will govern your program's operation.

1.1 Some Basics

Which Language – English or Bilingual Versions: There is generally no legal requirement to have the Employee Ownership program in German or at least in a bilingual version. However, while "German only" plans are rare these days (keep in mind that in some parts of Berlin you need high-school levels of English to order a flat white with trim soy milk), some start-ups use bilingual versions. Such a bilingual German/English plan might be very helpful when walking your German employees through the plan (remember, a plan that is not understood is just a waste of time and energy while still diluting shareholders) but a bilingual document will become even more lengthy and in a start-up with a very international and remote workforce, for many employees half of the plan will just be unreadable. Having a back-up convenience translation in a separate document or at least solid German language FAQ to accompany the "English only" plan might be better suited.

Employee Ownership Programs Are Often T&C's: There is another argument for making the program as easily understandable as possible and seeking to strive a reasonable balance between the interests of the various stakeholders (this is a lawyer's Latin for saying "don't take advantage of your employees"). In Germany, both an ESOP and a VSOP as well as the allocation letters with employees will usually qualify as standard business terms (*Allgemeine Geschäftsbedingungen*) and thus will be measured by courts against the more stringent requirements pursuant to secs. 307 et seq. German Civil Code (*Bürgerliches Gesetzbuch*—"**BGB**"). As a result, the provisions must be phrased clearly and unambiguously and may not unreasonably disadvantage employees. Here, provisions on vesting and forfeiture are regularly the focus of interest. Such provisions are not generally unlawful but must carefully address legitimate individual interests of the individual employee on a case-by-case basis.

One striking example is the famous decision by the BAG from March 2025 that—surprising to most market participants—outlawed the forfeiture of vested Awards in case of the employee simply deciding to leave the company without having good reason to do so. We will discuss this important decision and its ramification in Chapter A.IV.4.).

But Not in Every Case: BAG case law (see decision dated August 25, 2022, 8 AZR 453/21) has confirmed that Awards granted by the employer constitute employment remuneration and are subject to employee protection standards and applicability of T&C laws (*AGB-Recht*) as mentioned above. However, this is different when Awards are granted in a group structure by a foreign parent company rather than the direct employer. In such cases—where the Awards are conferred by an overseas parent under foreign law—the German labor courts have clarified that these Awards are not classified as employment remuneration under German law. Consequently, the German law standards applied for ownership programs, particularly those mentioned above for the forfeiture and leaver treatment do not apply when the German employer has not itself promised the Awards but only when the parent company grants them unilaterally.

How to Handle It the Right Way: In subsidiary/parent structures where Awards are issued by the parent company, *e.g.*, a U.S. Inc. under U.S. law, it is essential that the German employer does not inadvertently create obligations or promises regarding these Awards. Under no circumstances should such Awards be referenced as employer-granted Awards in a German employment contract, offer letter or side agreement. If these Awards become part of employment negotiations, the German employer must always make it unmistakably clear that the German employing entity is not responsible for the granting or administration of these Awards—they are exclusively the parents responsibility. Many employees, especially those unfamiliar with U.S. equity schemes, may not fully understand who is making what promise; clear communication avoids confusion and mitigates regulatory and liability risks.

1.2 The Plan and the Allocation Letter

We often see the documentation of Employee Ownership programs composed of two documents. There is the plan itself with its general rules including, among others, eligibility, general vesting and forfeiture rules, trigger events and a formula on how to calculate the cash payment the beneficiary is entitled to and many more things that lawyers consider worth putting on paper. This plan sets forth the rules that in general apply to all participants in the program.

The actual allotment of the Awards is then often made by executing a separate offer letter usually referred to as an **allocation letter** or an **allotment letter**. The allocation letter is addressed to the respective individual beneficiary indicating the allotment of a certain number of Awards and shall be signed by the company and the beneficiary. Usually, electronic signatures should suffice and no wet ink signatures are required.

Often, allocation letters specify matters such as the following:

- applicable number of allocated Awards;
- the start of the vesting period, also known as the effective date of the allocation (see below under Chapter A.IV.3.); and
- the strike price or base price for the Awards (see below under Chapter A.IV.2.2.).

In addition, allocation letters can also provide for special rules governing the circumstances under which the vesting shall be accelerated. Generally, the individual provisions set forth in an allocation letter will override the otherwise applicable general provisions set forth in the plan document. For example, if the parties wish to agree on a separate cliff period or another definition of good or bad leaver compared to the default definitions in the plan, this can be done in the allocation letter.

Sometimes the company also sets forth certain personal performance objectives (*persönliche Leistungsziele*) in the allocation letter, which need to be achieved by the relevant beneficiary as a condition for the allocation (and vesting) of some or all of the Awards in addition (or in lieu of) to the time-based vesting. For example, according to its IPO prospectus, *Home24* had issued Awards under a performance share scheme that were (in addition to certain EBITDA margin targets and a time-based vesting) subject to additional conditions including, for example, the successful implementation of certain projects or the assessment of the individual performance of the respective beneficiary.

Alternatively, VSOPs and PPRs can also be implemented by means of a single agreement that combines the aforesaid two separate documents (general terms set forth in the plan document and individual allocation terms set forth in the allocation letter). Note that for programs that are based on real shares, such as hurdle shares or sec. 19a shares, and that are limited to very few beneficiaries, the relevant provisions might not be set forth in a separate plan and allocation letter but can be incorporated in the start-up's shareholders' agreement because (unless the beneficiaries are pooled in a ManCo) the beneficiaries will become direct shareholders and for practical purposes will need to become parties to the shareholders' agreement anyhow.

2. DENOMINATION AND THE STRIKE PRICE

Let us briefly look at two other design features of many but not all Employee Ownership plans, denomination and the strike price. Denomination questions and the determination are only relevant for VSOPs and PPRs (real shares have a denomination of EUR 1 while the hurdle amount has an economically similar function as the strike price).

2.1 Denomination

So, how many Awards should there be? Apart from the obvious factor, the size of the Employee Ownership pool and individual grants expressed as a percentage figure of the fully-diluted cap table (we will discuss these aspects in Chapter A.V.1.2.), this question will also depend on the denomination of the Awards. In the United States, common shares in a start-up are frequently issued at a par value of USD 0.00001 per share. Thus, beneficiaries under a U.S. ESOP are used to receiving thousands or tens of thousands of options.

In Germany, with VSOPs, start-ups have the option to grant virtual shares that are not equal to the notional value of one common share but have a smaller split (the same can be done with PPRs). While the nominal value of a common share in a German start-up organized as a GmbH or an UG (*haftungsbeschränkt*) cannot be lower than EUR 1.00, this does not mean that the notional value of one virtual share must also be the equivalent of EUR 1.00 of a common share. It can also be, for example, 1/100th of this amount, resulting in virtual shares with a notional value that is economically equivalent to 1 Cent of common share capital.

In our experience, denominations of less than EUR 1.00 have become more popular over the last few years. The reasons are twofold. Obviously, it allows the start-ups to give more granular option grants. However, the more important reason is a psychological factor. First, as mentioned above, in the United States, employees are used to receiving larger quantities of options, so it can be perceived as a disadvantage in the job market when European start-ups give them a lower number (for some other important considerations when issuing Awards under a German VSOP to U.S. employees, see below under Chapter A.V.3.1.). In addition, for many folks receiving tens of thousands of something seems psychologically simply as "a lot" and preferable to a smaller number with higher unit values.

2.2 Strike and Base Prices

Classic stock options, *i.e.*, those that give their holders the right to purchase a certain number of real shares, are "struck" at a specific *strike price* when issued. The strike price (sometimes also referred to as *exercise price*) is the amount that the holder must pay to exercise the option, *i.e.*, to turn one option into one share. The expectation is that since the grant of the option and the simultaneous determination of its strike price, the underlying shares will have significantly increased in value and the holder will profit from the spread.

Typical German market Employee Ownership programs also know the concept of an economic strike price. However, in typical German market programs, the beneficiary does not need to actually pay the amount of the strike price. Here, the strike price works as a mere deductible that reduces the amount of money that the beneficiary is entitled to. This is obvious in case of a VSOP. Under a VSOP, the beneficiary receives upon an exit or liquidity event (only) a payment that is derived from the amount that a shareholder gets for a common share in the start-up (usually 1x or in case of lower denominations a fraction thereof per Award, *e.g.*, 0.001x, see above) minus the strike price set for the respective Award. But it is often also true for ESOPs where the concept of a strike price can be implemented in PPRs and even in case of an ESOP with real stock options as here options are often also settled in cash, *i.e.*, the beneficiary receives a payment in an amount equal to the sale price for the number of shares the beneficiary would have received for the options minus the relevant strike price.

To make clear that the beneficiary does not have to make any actual payment, German programs often use the term **base price** rather than strike price. For the purposes of this Guide, however, we will (continue to) uniformly use the term strike price for ease of reference.

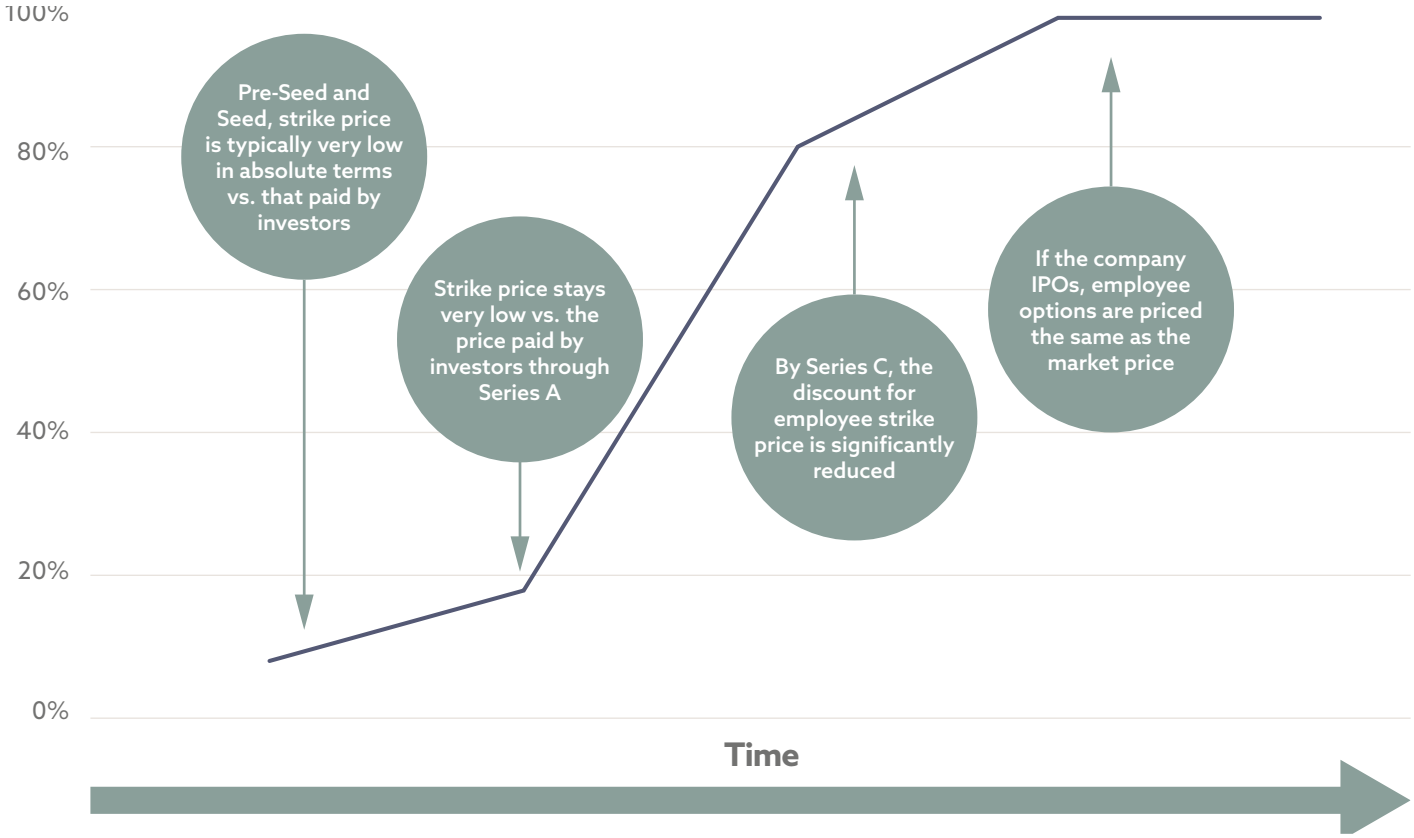
As lawyers should be, we are bad with numbers and will thus limit ourselves to some general considerations on how to set the strike price.

Discretion: For German employment participation programs, there is a lot of discretion on how to set the strike price. Unlike in the United States where the Internal Revenue Code sets limits on how low the strike price for options can be, no such rules apply in Germany (the same holds true for PPRs, but the strike price will determine the value of the instruments and thereby the necessary investment). Beyond the Seed stage, we see for example some start-ups setting their strike price at a certain fraction of the last financing round's pre-money (sometimes also the post-money) valuation with monthly or quarterly valuation increases. The rational for the discount from the last financing round's valuation is that—as already laid out above—Awards are supposed to economically simulate common shares.

The valuation accepted by the investor is, however, driven also by the various preference rights they receive over common shareholders (*e.g.*, liquidation preference and down-round protection).

Upward Movement: In most Employee Ownership programs, strike prices are initially very low or even zero and then go up through the various financing rounds. The initial very low price points are meant to incentivize the first employees as arguably they take the biggest risk in jumping ship to the fledgling newcomer. To that extent, the first cohorts of employees shall be equated in principle with the founders of the company, who also participate in the "entire" value increase of the start-up.

EMPLOYEE STRIKE PRICE/BASE PRICE VS. SHARE PRICE OF LATEST ROUND



Source: Based on graphic from Balderton Capital; see The Balderton Essentials Guide to Employee Ownership

3. VESTING

As we have seen, any incentive scheme needs to strike a delicate balance between attracting, keeping motivated and retaining the beneficiaries and rewarding them for future value-added work. If things don't work out as anticipated, the company needs to protect its shareholders as well as other beneficiaries from further economic dilution and windfall profits for the beneficiary who might have turned out not to be the expected contributor or who has decided to leave the company earlier than anticipated. Welcome to the territories of vesting and leaver provisions.

3.1 The Concept and the "Standard"

Put simply, vesting means that Awards must be earned by the beneficiary over time. The vesting schedule is the timetable over which a beneficiary accrues the right to keep the Awards that have been awarded. Vesting is a standard feature of Employee Ownership programs and protects the start-up. It stages the economic accrual of Awards, mitigating the risk that an employee will depart with an undeserved (virtual) stake in the company. It emphasizes the retention element described above as it continually incentivizes employees as they earn their Awards package over the course of the vesting period. In line with this purpose, Employee Ownership programs also usually foresee what is called a *cliff*, meaning that the individual must be with the company for the period of the cliff to vest the first increment of their Awards.

Though Employee Ownership programs in Germany do not have to be publicly filed, and so reliable figures are hard to come by, according to our experiences, a huge majority of the plans in German start-ups (at least those that are VC-backed) feature the following vesting provisions:

- Vesting period is usually set at 48 months, occasionally 36 months (but in the latter case, the Awards packages are usually somewhat smaller).
- Vesting occurs usually linear on a monthly basis; and sometimes on a quarterly basis.
- These days, the cliff period is almost always set at 12 months. So in case of the standard vesting period of 48 months with linear vesting, a 12 months' cliff means you get 0% vesting for the first 12 months, 25% vesting after the 12th month, and 1/48th (2.08%) more vesting each following month until the 48th month.

Keep in mind that vesting periods are usually agreed under the assumption that the beneficiary works full time for the company during the vesting period. Against this background, the plan should also foresee a clause that deals with a situation where the beneficiary has not left the company but reduces their time commitment.

It is for example standard to adjust/prolong the vesting period in the following cases: sick leave for periods in excess of those for which the company is obliged to pay salary pursuant to the continued remuneration laws or during any other voluntary or involuntary, paid or unpaid leave of absence except annual vacation. However, we think that for company culture and other reasons, the vesting should neither be suspended nor tolled during the mandatory period during which a beneficiary is on maternity leave and for periods of parental leave. It is often a sensible compromise to suspend further vesting only if the beneficiary takes parental leave of more than three months per child or more than six months in case of several children.

When an employee transitions from a full-time to a part-time commitment, companies face a strategic decision about how to adjust their equity participation. Two primary approaches emerge: extending the vesting period or reducing the Award allocation *pro rata* while maintaining the original vesting schedule. Each approach has distinct implications for retention, fairness and administrative complexity.

One alternative is to maintain the original Award size but extend the vesting period proportionally. The employee retains the full economic upside of their original grant, preserving the motivational impact of their equity stake. This approach recognizes that part-time employees may still contribute significantly to company success, particularly in senior or specialized roles. The Award value remains unchanged, avoiding complex recalculations of grant economics or tax implications. Finally, one can argue that extended vesting can actually strengthen retention by creating longer-term alignment. However, imagine that an employee moves to a 50% time commitment and their (remaining) vesting period doubles. That can be a long horizon to imagine. In addition, full-time employees may view extended vesting as preferential treatment, particularly if the part-time employee's actual contribution decreases significantly.

Alternatively, the plan can foresee a *pro rata temporis* reduction of the unvested Award allocation proportionally to the time commitment reduction while maintaining the original vesting schedule. This approach maintains direct correlation between time commitment and equity participation, which most employees intuitively understand as fair. Nevertheless, valuable part-time contributors might leave rather than accept reduced equity participation, particularly if they have attractive alternatives. Against this background, some companies implement hybrid approaches that consider both time commitment and performance. A part-time employee who maintains high productivity might receive a smaller reduction than one whose contribution decreases proportionally.

3.2 Keep Thinking – Alternative Structures

However, founders and investors should also consider some alternative structures to the standard model described above that in certain cases might be more appropriate to align the parties' interests.

Some companies have decided to put more emphasis on the longer-term retention element of Awards as they considered the standard model to be too focused on the point in time when the employee needs to be lured to the start-up while neglecting sufficient incentives to actually stick around for the long haul, read at least the agreed vesting period. To discourage "job hopping" and minimize the frictions and value-destruction caused by employee churn, companies have, for example, resorted to the modifications of the standard model discussed in this Chapter.

3.2.1 Longer (or Shorter) Vesting Periods

The German market has largely converged on four-year vesting periods as the standard for Employee Ownership programs, mirroring U.S. market practices. This four-year term has become deeply entrenched across the German start-up ecosystem, from early-stage companies through to late-stage scale-ups.

To address talent competition and the shorter employee life cycles we discussed above (see Chapter A.II.2.), some start-ups reduced the vesting period to three years. But longer vesting periods?

In the past, we did only very rarely encounter vesting periods in excess of the standard four-year model (apart from the customary tolling provisions if a beneficiary shouldn't work full-time during such period, of course). However, every now and then, a start-up decides to break new territory, *e.g.*, *AngelList* who is said to have used a six-year vesting period. German unicorn *Enpal* also went into this direction and in 2024 founder CEO *Mario Kohle* claimed in the *Unicorn Bakery* podcast: "We probably have the longest vesting in the world. For us, the vesting is seven years for everyone" [note convenience translation by the authors].

While we cannot make statistical claims whether or not this is already a trend, in our own practice we have seen over the last quarters several German start-ups experimenting with five- to six-year vesting periods, particularly for senior roles with larger Award allocations. The goal is obvious: align equity incentives with longer-term strategic objectives. In some cases, longer vesting periods were used when the company planned for a longer path to exit to ensure key talent remains through extended growth and harvesting phases. One of our clients experiments with performance-linked adjustments of the vesting period, *i.e.*, the standard vesting period of four years can be shortened to three years or extended to up to five years based on performance milestones or company achievements.

3.2.2 Longer Cliffs

While some firms have decided to stick to the concept of a linear vesting, they implemented a longer cliff period of up to 24 months (in rare cases even longer, though then the longer cliffs are usually reserved for certain key executives) compared to the standard cliff period of 12 months.

Extended cliff periods fundamentally alter the risk-reward equation for both companies and employees. Under a 24-month cliff structure with a standard four-year vesting period, employees who leave before their second anniversary receive no equity compensation whatsoever. However, those who reach the 24-month milestone immediately vest 50% of their total Award allocation, with the remaining 50% vesting linearly over the subsequent two years. This creates a very different incentive structure compared to traditional 12-month cliffs. The extended cliff period significantly increases the (perceived) financial penalty for early departure. The psychological impact of extended cliffs cannot be understated. Employees approaching an 18-24-month cliff face a much more significant financial decision when considering departure than those with traditional 12-month structures. On the flip side, extended cliff periods can create significant barriers to talent acquisition, particularly for mid-level professionals who may be unwilling to accept the increased risk of no equity compensation for extended periods. This is especially challenging in competitive markets where candidates have multiple options.

According to its IPO prospectus, *Westwing* implemented a long-term incentive scheme in 2016 for members of the company's management that included a 36-month cliff period. This extended cliff was specifically designed for senior executives whose departure would have significant strategic impact on the company's operations and competitive position. We are also aware of several German companies that have adopted 18-24 month cliff periods for senior technical roles, particularly in artificial intelligence and blockchain sectors where specialized knowledge is critical and replacement costs are exceptionally high. Here, the company's rationale might go as follows: "In deep tech, where it takes 18 months just to understand the product architecture, a 12-month cliff barely covers the learning curve. Extended cliffs ensure we're retaining people who've actually contributed to the business".

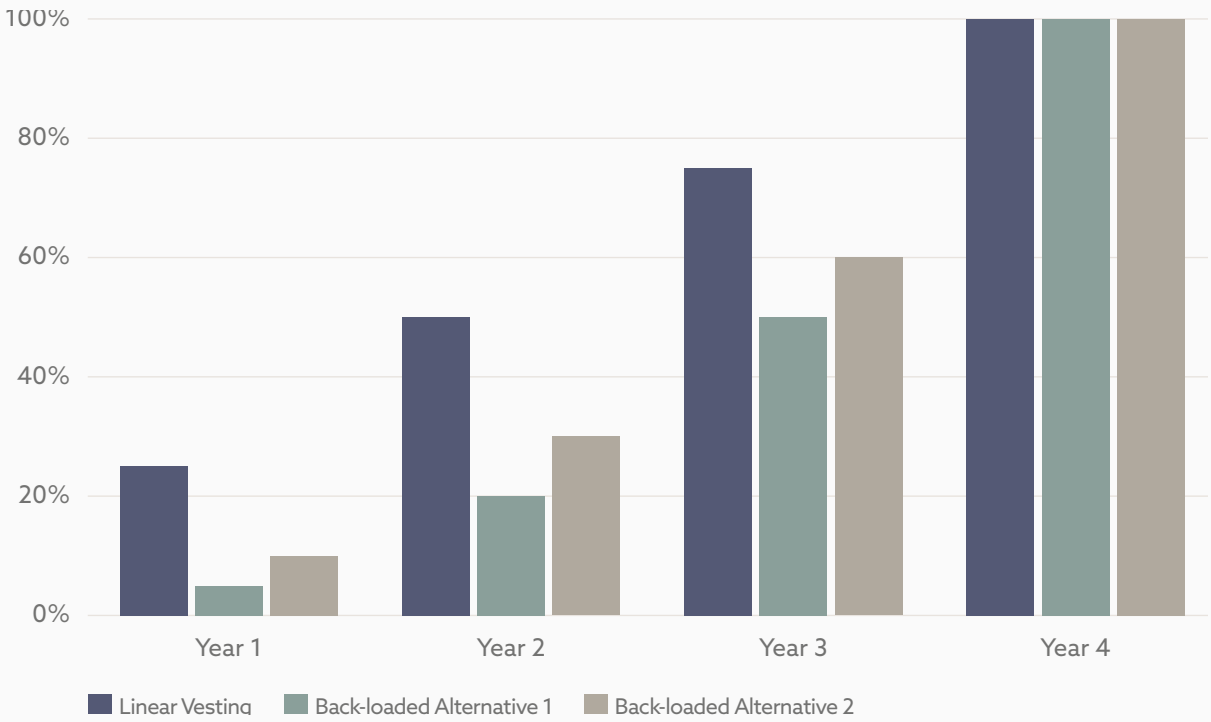
German employment law's emphasis on proportionality suggests that cliff periods must be reasonable in relation to the role's requirements and the employee's contribution timeline. Courts would likely evaluate extended cliffs based on factors such as role complexity, training requirements and industry standards. While many legal practitioners consider cliff periods of up to 24 months to be permissible under German employment law, the landscape remains somewhat uncertain. There is no decisive case law from the BAG establishing the maximum permissible length of a cliff period.

3.2.3 Back-loaded Vesting

In deviation from the classical linear vesting over four years, start-ups can use vesting schemes that allow the beneficiaries to accumulate the larger portion of their options only in the second half of the vesting period.

The Concept: For example, instead of giving a beneficiary 25% vested Awards after each of the four years making up the vesting period, a back-loaded scheme could for example foresee 5% of the Awards to vest after year one, another 15% in year two, while the bulk of the Awards would only vest in years three (30%) and four (50%). An alternative structure could foresee a vesting of 10%, 20%, 30% and 40% over the four years. Respectively. The adjacent graphic shows the outcomes after each full vesting year compared to a classical linear vesting. Note that during each year the respective annual portion will usually vest linearly (except for the initial cliff period, of course).

TRADITIONAL VS. BACK-LOADED VESTING SCHEDULE



For example, at some point, *Snapchat*, *Amazon* and *Farfetch* have used such back-loaded vesting schemes.

Back-loaded vesting remains relatively uncommon in the broader start-up ecosystem, with most companies preferring the simplicity and market acceptance of linear vesting structures. However, in our experience, these structures are more frequently deployed in Germany than in the United States.

Further, adoption is higher in sectors with naturally longer value creation cycles, such as biotech, and deep tech, where the rationale for back-loaded vesting is more easily justified and understood. Some companies implement modified back-loaded structures (such as 15%, 20%, 30%, 35%) that provide some acceleration without being as dramatic as heavily back-loaded schemes.

Advantages: There are a couple of strategic advantages that lend support to a back-loaded vesting scheme:

- **Enhanced Long-term Retention:** Back-loaded vesting creates increasingly powerful retention incentives as employees progress through their tenure. The knowledge that the majority of equity value remains unvested in years three and four creates strong financial motivation to complete the full vesting period rather than leaving early. In particular, now that the new BAG ruling requires voluntary leavers to be treated as good leavers, a back-loaded vesting scheme protects the company against "job hopping" where beneficiaries jump ship midterm through their vesting period and keep 50% of their Award allocation (a strategy that allows beneficiaries to build up a portfolio of start-up equity stakes over the average 8-10 years that it takes for most German start-ups to come to an M&A exit).
- **Performance Alignment:** This structure aligns well with employee value creation patterns, as most employees become significantly more productive and valuable to the organization in their later years when they have deep institutional knowledge and established relationships.
- **Strategic Project Completion:** Back-loaded vesting works particularly well for roles involved in multi-year projects or product development cycles where the greatest value creation occurs in later phases.

But there are also a couple of drawbacks that need to be considered:

- **Talent Acquisition Challenges:** Candidates may be reluctant to accept positions with back-loaded vesting, particularly experienced professionals who expect more immediate equity participation. This can put companies at a competitive disadvantage in tight talent markets.
- **Employee Morale Concerns:** The perception of "earning less" in early years compared to linear vesting can impact employee satisfaction and motivation, particularly if not clearly communicated and justified. In addition, employees who feel their equity accumulation is too slow may be more likely to leave before reaching the higher-value vesting periods, potentially defeating the retention purpose.
- **Cash Compensation Pressure:** Companies may need to offer higher base salaries or other compensation to offset the delayed equity gratification, impacting cash flow during growth phases.

3.2.4 Performance-based Vesting

Another approach to shifting the beneficiaries' attention more to longer-term value creation and the top goals of a start-up in its infancy (usually growth, growth and did we mention growth?) is a performance-based approach to vesting schemes. We also see sometimes (though in recent years not that often) companies that blend a traditional time-based vesting with a performance-based vesting. Such approach is usually reserved for certain senior executives who occupy roles that can move the needle (*e.g.*, sales) and often goes something like this: a certain portion of the Awards simply vests over time while another portion only vests if certain pre-defined targets are hit, *e.g.*, sales quotas or revenue/growth targets.

3.3 Acceleration

In this and the next Chapter, we want to look at two hot topics and potential minefields around the questions on when Awards are actually earned. One is the question if and under which circumstances a vesting may be accelerated in case of a liquidity event/exit during the vesting period and the other even more relevant one revolves around what should happen if the beneficiary for whatever reason does not provide services to the company until the Awards are vested, *i.e.*, becomes what is commonly known as a "**leaver**".

Please Note: Acceleration provisions are not standard features in many U.S. Employee Ownership programs and, when included, are typically reserved for senior roles and key employees. However, we frequently observe that start-up boards voluntarily grant some form of acceleration at the time of exit, even when not contractually required. The likelihood of such discretionary acceleration varies significantly based on several factors:

- employee seniority levels (substantially more common for key executives and mission-critical employees);
- deal size, structure and strategic rationale;
- competitive dynamics and timing pressures of the exit process; and
- board composition and investor philosophy regarding employee rewards.

Acquirers often advocate for acceleration to ensure key team members feel appropriately rewarded for their contribution to exit value and remain motivated throughout the integration process.

When voluntary acceleration is granted, partial acceleration covering 25-50% of unvested equity is more common than full acceleration of all unvested Awards.

Single or Double Shots? In short, acceleration provisions allow the beneficiaries to vest (at least a portion of) their Awards before the scheduled date due to the achievement of a milestone, for example, a performance target set forth in the allocation letter. Far more often, acceleration is, however, tied to the occurrence of a liquidity event, usually an exit transaction such as a sale or an IPO of the company. In start-up jargon this is called a "trigger" and a provision that requires only the occurrence of an exit to accelerate vesting is called a "**single trigger acceleration**".

However, acceleration provisions in case of an exit are a double-edged sword. While it is important to incentivize a start-up's key executive team to work hard towards a value-maximizing and timely exit without them thinking about their ticking vesting schedule as an unwanted distraction, founders and investors of the start-up need to keep in mind that an exit-triggered acceleration might negatively impact valuation and make the overall exit process more complex and challenging to navigate. The reasons are two-fold.

- Obviously, higher costs for the Employee Ownership plan will diminish their returns as the buyer will factor any such liabilities into its equity bridge for the company (if the start-up has to bear the economic burden of the program itself) or the existing shareholders will have to reimburse the company for its payments to Award holders or assume such liabilities outright, in each case reducing the size of the pie they can keep.
- Less obvious but equally important is to put oneself in the shoes of the buyer. In every start-up M&A due diligence, one thing will be for sure: the company has not been optimized for post-merger integration. Moreover, for a buyer, the start-up's team is often one of the most valuable assets for which they are paying. So, what if the exit transaction becomes an unexpectedly large payday for the target's key executives who can now also cash in their unvested Awards? Some of them may decide to sail into the sunset having already received a life-changing sum of money or at least to finally go onto that long-dreamed-of sabbatical. Not ideal for a buyer who will usually not have a team of its own hotshots waiting on the sideline to be parachuted into the start-up to fill these gaps. As a general partner of an international venture investor put it at a portfolio day a few years ago: "Acceleration provisions are often the difference between a successful acquisition integration and a talent exodus. We've seen too many good deals go bad because everyone cashed out and left". Single-trigger acceleration can also have a chilling effect on M&A in another way: It can create perverse incentives when acquisition rumors start, and productivity can fall off a cliff when people are just waiting for the exit.

> "All-employee acceleration is bad practice because you are sending the message that an acquisition is the end of the road. Buyers would definitely disagree with that."
>
> *Dominique Vidal*, Partner at Index Ventures

Against this background, typical U.S. programs of VC-backed start-ups have implemented what is called a "**double-trigger acceleration**". These provisions let the beneficiary benefit from an accelerated vesting of their unvested portion of Awards

- upon occurrence of an exit (this is trigger no. 1); but
- only if the beneficiary is involuntarily terminated within a certain period of time after the exit, usually 12 months (only rarely longer) or leaves the company during such period without good cause (this is trigger no. 2).

Practical Implementation and Strategic Considerations: In our experience, the German start-up ecosystem has over the last years moved more and more towards double-trigger acceleration, influenced by international best practices and investor preferences. However, differences across stages and industries remain.

- For the first cohort of employees, the risk is the highest and a single-trigger acceleration might be added into the compensation mix to win them over. In the growth and later stages, M&A exits might become more likely and double-trigger acceleration is more widely adopted.
- Some start-ups also differentiate according to the roles of the beneficiaries with top executives often getting single-trigger acceleration for their Awards (cynical observers might wonder whether they are at the highest risk of being fired first after an acquisition).
- And as Germans always like to make matters more complex, we have also implemented programs where a portion of the unvested Awards is subject to a single-trigger acceleration but to counter the typical "Neid" argument, another portion was subjected to a double-trigger acceleration.

As the German start-up ecosystem continues to mature and produce more exit events, the lessons learned from both successful and problematic acceleration implementations will continue to refine best practices and market standards.

4. LEAVER PROVISIONS

There is a second question around vesting that can often cause frictions and where, at least until very recently, U.S. and German market standards still deviate to some extent: leaver provisions.

Quoting one last time from our favorite novel "Captain Obvious in the Echo Chamber": Employee Ownership programs not only have to incentivize an employee to join a start-up, they also have to incentive them to stay with it, at least for some time.

That is why these programs universally feature vesting provisions as described above. They shall ensure that an employee earns their slice of the pie over time (or through performance). However, the Employee Ownership program will usually not only stipulate that vesting stops if the beneficiary ceases to work for the company prior to expiration of the vesting period, *i.e.*, becoming a leaver, but will distinguish between the reasons for such leaver event. Depending on the respective reason, the leaver may keep more or less (down to zero) of the value of their (vested) Awards.

Common point of departure is that upon the occurrence of a leaver event, the beneficiary loses all unvested Awards. This is a standard feature. The question is, what happens to the vested Awards? Shall the beneficiary be allowed to keep them and benefit from them in the future when they have increased in value although the beneficiary didn't actively contribute to the value-add after their departure? On the other hand, haven't they helped the start-up to get that far and helped build the basis on which such future success rests?

4.1 The Good, the Bad and the Grey

Many founders and investors believe that one needs to distinguish between beneficiaries who deserve protection and those who, due to their behavior, have lost such protection.

Against this background, many Employee Ownership programs distinguish between good and bad leavers. The consequence is often that good leavers can keep their vested Awards while bad leavers lose them. In most cases, bad leavers lose all their vested Awards; occasionally we come across plans where bad leavers only lose a portion of their vested Awards or only get a significantly reduced payment for their vested Awards upon exit but can otherwise keep them.

Good Leaver: Cases in which a beneficiary is usually considered a good leaver who can keep their vested Awards include, for example, the following:

- The beneficiary dies or becomes permanently unable to perform their services (*dauernd berufsunfähig*). If you ever asked yourself why lawyers are usually not invited to dinner parties, then maybe labelling a dead beneficiary as a "good leaver" is part of the answer...
- The beneficiary is dismissed by the company without cause within the meaning of sec. 626 BGB (*Kündigung aus wichtigem Grund*).
- The beneficiary resigns for good reason (legacy Employee Ownership program often specified what shall be considered a good reason, *e.g.*, having to take care of a sick close relative or reaching retirement age). We will discuss the treatment of a resignation without good reason in a minute.

Bad Leaver: Cases in which a beneficiary is usually considered a bad leaver who would forfeit all or at least a portion of their vested Awards include, for example, the following:

- The beneficiary is dismissed for cause within the meaning of sec. 626 BGB.
- The beneficiary materially violates compliance rules or a code of conduct.
- The beneficiary (materially) violates a post-contractual non-compete undertaking.

Treatment of the Voluntary Leaver – A German Sonderweg: In Germany and some other European start-up hubs, the sentiment to leavers was for a long time often decidedly different than in the United States where the good leaver is the norm and there are usually significantly narrower definitions of what constitutes a bad leaver. Case in point: An often-debated question in German start-ups was whether employees who simply choose to leave or are terminated for poor performance (which in itself does not constitute "good cause" for a termination under German law) should qualify as bad leavers. In the United States, both cases would hardly ever qualify as bad leavers. In Germany, the situation was different. Here, some plans (used to) qualify such beneficiaries as bad leavers (at least if the voluntary departure occurs during the first half of the vesting period which in practice translated into a partially longer cliff period) or treated them as "grey leavers" (see below).

Numerous international and an increasing number of German investors have argued for an adoption of the more lenient U.S. approach and advise not to foresee bad leaver provisions at all or at least exclude the aforesaid cases of a voluntary leaver or underachievement and limit bad leaver provisions to "really bad behavior", *e.g.*, fraud, criminal misconduct or certain cases of unethical behavior. The main reasons being: Starting your relationship with a new hire by negotiating the conditions under which they could lose their ownership stake sets the wrong tone for their future at the start-up. Plus, there is a reputation element as the forfeiture of voluntary leavers' Awards will always be debated inside and outside of the start-up and can cause concern in existing and prospective employees about the value of their own stakes in the Employee Ownership program. As a consequence, the argument goes, a start-up can get a competitive edge in the job market if it is known that its employees will be able to retain their earned part of the company's past success (more or less) regardless of the circumstances of their departure. For completeness, we should add that the most common approach in the United States is not quite as employee-friendly as it may seem at first sight. This is because U.S. employees, regardless of the circumstances of their departure, must generally exercise the vested Awards within a relatively short period (usually not more than 12 months). It's not unusual that the strike price makes this unaffordable or too risky at such point in time, forcing the employee to let the Awards lapse.

In recent years, we have already seen some movement into this more employee-friendly approach like the implementation of so-called grey leaver provisions. These provisions let employees often keep at least a portion of their vested Awards in case of a voluntary leaver during the vesting period. However, in our opinion, on average, Employee Ownership programs in Germany still used to lag their U.S. peers when it came to employee-friendly leaver provisions up until March 2025.

And Along Came the BAG: In March 2025, the BAG (see decision dated March 19, 2025, 10 AZR 67/24), Germany's highest labor law court, surprised wide parts of the start-up ecosystem when it reversed its prior decisions and set a new, clear standard: Employee Ownership program clauses that classify a voluntary resignation as a "bad leaver" event—leading to the forfeiture of already-vested Awards—are now invalid. To be precise, that is if the beneficiary is an employee and the Employee Ownership plan qualifies as terms and conditions (which will often be the case). The court made it explicit that taking away vested Awards from an employee who leaves the company without any misconduct constitutes an unreasonable disadvantage and is therefore unenforceable. In other words, the "earned" part of the equity stake is now protected by law, regardless of the circumstances of the departure, as long as there is no bad faith or gross violation of duties (we will discuss whether and under what circumstances so-called "negative vesting" clauses are still permissible in a second).

This means that the position long advocated by international VC investors has now become the legal reality in Germany. The long-standing uncertainty around the treatment of voluntary leavers has now been resolved, with German Employee Ownership programs required to ensure that vested Awards remain with the beneficiary unless there is a serious breach of contract. In practice, this brings German Employee Ownership programs much closer to the U.S. model and makes these plans fairer, more predictable and ultimately more attractive for talent.

4.2 Navigating the New Landscape – Structuring Options After the Latest BAG Ruling

The landmark BAG decision has fundamentally reshaped the Employee Ownership landscape, forcing a comprehensive reevaluation of established practices across the German start-up ecosystem. This ruling has not only invalidated common forfeiture provisions but has also catalyzed a wave of innovative structuring approaches among start-ups and their legal advisors. The central challenge facing companies today is designing Employee Ownership programs that simultaneously comply with the new legal boundaries while maintaining their effectiveness as retention and motivation tools. While we have examined many of these alternative retention strategies in detail throughout this Guide, this section consolidates them within the specific context of post-BAG compliance. The decision has created a need for founders and investors to pause, reassess and rethink their Employee Ownership plan architecture. The following structuring options represent the emerging best practices that balance legal compliance with commercial effectiveness in this new regulatory environment.

4.2.1 Buy-back Rights and Negative Vesting

These new boundaries are driving new questions—and new strategies—about how to structure VSOPs and ESOPs in a legally sound and fair way. In particular, the following two practical responses are currently under discussion:

Buy-back Rights: One practical response to the legal limits on forfeiting vested Awards, as outlined above, is to implement a buy-back right in favor of the company. In this case, the Employee Ownership program grants the company a time-limited option to buy back the beneficiary's vested Awards at the fair value when the beneficiary leaves the company.

While in the United States, ESOP beneficiaries often only have a limited time window following their leaver to decide whether or not to exercise their vested options, *i.e.*, make up their minds about the likely prospects of the company and "put money on the table", the situation in Germany is different. Vested Awards can usually be kept until an exit occurs (except for the relatively rare cases where the plan foresees a "negative vesting" following the beneficiary leaving the company, see below). This gives beneficiaries the opportunity to build up a portfolio of Awards by job hopping every two years or so and then wait and hope for the value of their Awards to accumulate while hedging their bets through building up a diversified portfolio of Awards from various employers.

Here, some companies seek to cap the upside of such Awards while still allowing the beneficiary to retain their vested Awards. One way to achieve this goal is to allow the company to settle vested Awards within a certain period of time following the occurrence of a good leaver at a valuation that is usually derived from the pre-money or post-money valuation of the last financing round that the start-up has raised (a discount may be applied as well).

This approach is attractive for companies looking to keep their (fully-diluted) cap table clean and avoid a large pool of former employees with economic rights. However, founders then need to explain well the rationale behind such clauses to the beneficiaries as any limitations on the potential upside of the Awards a beneficiary considers "earned" will make the program somewhat less attractive.

> "I have some sympathy for buy-back rights, especially for real equity programs. When beneficiaries leave, negotiations can sometimes get messy fast. A unilateral buy-back right gives start-ups leverage to reach reasonable solutions. We don't want 'option nomads' hopping companies every few years—clean exits mean clean slates, even for virtual participation."

Ansgar Schleicher, general partner at TechVision Fund

(Sufficiently Long) Negative Vesting Periods: Some ESOPs include provisions under which vested Awards gradually forfeit after the termination of the employment relationship. The effect of such provisions is that the longer the beneficiary has been separated from the company, the more of the vested Awards will be forfeited. This approach is called "negative vesting".

According to the BAG's judgment, such clauses set out in general terms and conditions shall be invalid if they fail to fairly account for the length and value of the beneficiary's service for the company. Specifically, the BAG takes issue with negative vesting schedules under which vested Awards forfeit faster than they are vested. For example, a clause that causes Awards to forfeit within a two-year period after employment ends—when those Awards had to be earned over a four-year vesting period—is therefore invalid.

Thus, an Employee Ownership plan can foresee a negative vesting plan, but the timeline for any post-employment forfeiture must be at least as long as the original vesting period and cannot be more restrictive.

Negative vesting can come in a variety of forms:

- The vested Awards can "unvest" (be forfeited) gradually each month over a sufficiently long period of time (usually we see a linear forfeiture).
- The negative vesting scheme can also foresee a "negative cliff", *i.e.*, that all vested Awards are not forfeited gradually over time but all at once upon the expiration of a certain period of time following the leaver event, provided that no exit or liquidity event has occurred prior to such date.
- Others are taking more nuanced routes: For example, only a portion of the vested Awards (say, 50%) is subject to negative vesting, allowing employees to keep a significant part of what they have earned. Another option gives leavers a choice: either accept negative *vesting* and participate with the remaining portion in a future exit event or retain the full vested portion but agree to a cap on potential payouts based on the company's value at departure.

4.2.2 Alternative Approaches – Retention over Punishment

The practical responses outlined above can be understood as an outflow of an underlying assumption that beneficiaries who leave the company voluntarily prior to the expiration of their vesting period should be "penalized" in some way by forfeiting at least a portion of their economic benefit. While we understand the rationales for these approaches, we also recognize that any form of penalty for a behavior that the beneficiary would consider legitimate can be a disadvantage in the fight to attract and retain international talent. If the aforesaid approaches may be characterized as clawing back previously granted benefits, it prompts a closer consideration of what alternative structures might be available.

Extending the Cliff Period (see also Chapter A.IV.3.2.2.)**:** Extending the cliff period delays the commencement of the vesting of the options and thus ensures a minimum stay period. However, once the cliff period expires, the Awards that would have been vested during that time (if there was no cliff period) will vest all at once. Consequently, beneficiaries are incentivized to stay longer with the company in order to receive these Awards at all. If beneficiaries leave the company during the cliff period, they will not receive any Awards. However, since the Awards have not yet vested, nothing is "taken away" from them. It is important to ensure that the extension does not unduly disadvantage the beneficiary. A 12-month cliff is typical in many Employee Ownership programs. We believe that an extension of the cliff period from 12 to 24 months is also permissible while much longer cliff periods might rest on shaky ground. Unfortunately, we will need to wait for the courts to provide some guidance on what maximum cliff periods are acceptable.

Back-loaded Vesting (see also Chapter A.IV.3.2.3.)**:** In deviation from the classical linear vesting (*e.g.*, 25% per year over four years), back-loaded vesting allows the beneficiaries to accumulate the larger portion of their options only in the second half of the vesting period. For instance, 10% of the options vest after year one, another 20% after year two while the bulk of the options would only vest in years three (30%) and four (40%).

Longer Vesting Periods (see also Chapter A.IV.3.2.1.)**:** So far, we have relatively rarely encountered vesting periods beyond the standard four-year model (apart from the customary tolling provisions if a beneficiary shouldn't work full-time during such period, of course). However, every now and then, a start-up decides to break new territory and at least for senior executives with larger one-time allocations of Awards, we might see a more widespread use of this approach.

Refresher and Top-up Grants (see also Chapter A.V.2.2.)**:** Instead of a large one-off grant at the beginning of employment, companies can offer additional refresher or top-up grants over time. This creates a rolling incentive to stay and keeps equity motivation fresh throughout an employee's tenure.

Performance-based Vesting: Rather than vesting purely over time, some companies tie vesting to performance milestones—such as achieving revenue targets, product milestones or successful financing rounds. Companies like *Uber* and *Palantir* have used milestone vesting structures for executive teams. In our experience, in Germany, this approach is still relatively rare but might become more widely adopted at least with senior executives in the future.

For example, *Pfisterer*, a German electrical engineering and power transmission company, implemented a one-off IPO-related virtual share option program (VSOP 2023) in 2023-2024 for management board members and certain key employees as a retention and incentive mechanism. The program features a dual-vesting structure: 50% of virtual shares vest immediately upon IPO completion with payouts based on the difference between the offer price and agreed strike price, while the remaining 50% vest over two years post-IPO (25% after year one, 25% after year two) with values determined by the volume-weighted average share price over the 10 trading days before each vesting period. The company retains flexibility to settle claims in either cash or shares, according to their IPO prospectus dated May 5, 2025.

5. TRIGGER EVENTS AND PAYMENT AMOUNTS

In this Chapter, we discuss the typical trigger events for many Employee Ownership plans and how payment amounts are calculated in case of a typical VSOP (similar considerations apply to PPRs while the payment amount for growth shares is largely determined by the applicable waterfall and basically whatever a holder of a common share gets minus the hurdle amount). Later in this Guide, we will discuss how Employee Ownership plans are actually settled in case of an exit event (see Chapter A.V.4.2.).

5.1 Calculation of the Payment Amount

Sale of the Company: If the company is sold (for other forms of exit transactions, please see further below), the holder of a common share will get their *pro rata* share of the exit proceeds following the application of the (hopefully non-participating) liquidation preferences granted to the holders of preferred shares, *i.e.*, the investors.

The Employee Ownership program will contain detailed provisions about what constitutes a "sale", usually defined as a transfer of more than 50% (recently, we occasionally also see 75%) of the company's issued and outstanding share capital to a third party (which should generally also include an existing shareholder) in a single transaction or a series of closely related transactions.

Under a VSOP, an Award solely represents the beneficiary's right to receive a payment (usually in cash) in case of a sale of the company. Here, the Award is only used as an assessment basis (*Bemessungsgrundlage*) to calculate the gross amount of such a payment. In a typical VSOP, the plan will provide that the Award will entitle the beneficiary to a gross amount equal to the exit proceeds remaining after deduction of all transaction costs (and often some other exit-related costs) that a holder of a common share would be entitled to per one common share or a fraction thereof (*e.g.*, 0.01x of that amount in case that 100 Awards equal one common share) minus the strike price. In a typical VSOP, the formula to determine the payment amount can, for example, look as follows:

BEP = VVS x (EP[■x0.01]-BP)

"BEP"	means the respective beneficiary's aggregate exit payment (gross)
"VVS"	means the number of vested Awards of the relevant beneficiary (maybe after application of accelerated vesting)
"EP"	means exit proceeds per common share (after deduction of all transaction costs etc.); and
"BP"	means the strike or base price for the respective Awards of the respective beneficiary

In cases where not all common shares are sold in the exit, some programs also add a factor to the formula that reduces the entitlements *pro rata* to the percentage of common shares sold in the exit.

As lawyers, we cannot leave a simple case as is and consider (perceived) under-complexity a sin. One example: In start-up M&A, we often have the situation that it is not immediately clear on the day of closing how much the seller of a common share will ultimately get/be allowed to keep. Case in point: The acquisition agreement can foresee subsequent or conditional proceeds or performance-based subsequent payments (*e.g.*, earn-out payments). The agreement can also foresee purchase price retentions or payments into an escrow account (*Sicherheitseinbehalt*), usually as a security measure for potential guarantee claims of the buyer(s) against the holders of common shares. Given these uncertainties about the ultimate amount of exit proceeds that will flow to the holders of common shares, the Employee Ownership programs should foresee a clarification that any such payments should be either disregarded when determining the entitlements under the Employee Ownership plan (unless the company's advisory board or shareholders' meeting determines otherwise) or at least only be considered if and when actually received (some plans also differentiate between escrow and retention amounts (to be considered if and when received) while earn-out payments shall be disregarded, which will make the settlement of the Employee Ownership plan a bit more complex) (see also Chapter A.V.4.2.).

Asset Deal Exit: The aforesaid paragraphs dealt with the situation when the start-up is sold to a buyer by way of transfer of the shares in the company. However, there are other forms of an exit including, in particular, an asset deal and an IPO.

Other than by means of a share sale in the start-ups, the shareholders can also economically exit their positions by letting the company divest its assets, then distribute the resulting proceeds to the shareholders and subsequently liquidating the (more or less empty) start-up. This is usually referred to as an "*asset deal exit*" and most Employee Ownership programs consider such an asset deal a trigger event for the beneficiaries' payment rights under the plan. In this case, the amount of the payment claim is calculated using the formula for company sale exits described above, provided that instead of the amounts of net sale proceeds resulting from the share sale, the amount of distributable proceeds from the asset sale is used (pro-rated to one common share or a fraction thereof).

IPO: Another exit situation is a listing of the company, either by way of a classic IPO, a direct listing or a De-SPAC transaction (We know, but maybe they will come back again. Who would have thought that mechanical keyboards from the 1980s and 1990s would make a comeback as a status symbol for serious coding?). Regarding the latter two forms of a listing, some legacy Employee Ownership programs are not particularly precise, which can result in discussions down the road.

Regarding an IPO, customary plans frequently foresee that upon the completion of the listing, all unvested Awards are forfeited. For vested Awards, the company is often given the right to settle some or all of them in cash and/or to exchange, substitute or replace some or all of the vested Awards with options to acquire actual shares in the company reasonably prior to or at any time following the occurrence of the listing. In case of a cash settlement, the payment amount is derived from the trading price of the company's shares after the initial listing (usually the average trading price over a certain period of time, *e.g.*, 20-30 trading days, is used to smooth out the customary fluctuations shortly after the initial listing).

5.2 Payment Terms

In case of a share sale or asset deal exit, the respective payments to the beneficiaries are made within a certain reasonably short period of time after the exit transaction has closed, often within a few weeks.

In the past, Employee Ownership programs sometimes included clawback mechanisms designed to maintain post-exit retention. Under these arrangements, the company would withhold a portion of the payout amount—typically around 20% to 25%—that beneficiaries would otherwise receive upon an exit event. This withheld amount would only be released if the beneficiary remained employed (absent termination for good reason) for a specified period following the exit, usually 12 months.

However, such provisions are now legally problematic under the new BAG ruling. These clawback mechanisms essentially function as "revesting" of previously vested Awards, creating a subsequent forfeiture risk for benefits that employees have already earned. Given that the BAG decision prohibits the retroactive forfeiture of vested Awards, the permissibility of such provisions is uncertain.

To achieve similar post-exit retention objectives while maintaining legal compliance, companies should consider alternative approaches that stand on more solid legal footing. Double-trigger acceleration provisions combined with more frequent top-up or refresher grants can provide comparable incentives for employees to remain with the company following an exit, without creating the legal vulnerabilities inherent in clawback mechanisms.

6. HOW LAWYERS FILL THE REMAINING PAGES

Employee Ownership programs can easily be more than 20 pages long. Here are just a few of the other things that lawyers like to spell out in these plans that we haven't yet discussed:

- In particular in VSOPs and PPR plans, there will be clarifications that the Awards do not entitle the beneficiary to subscribe to or acquire actual shares in the company and are not vested with any information, participation, voting, dividend or other shareholders' rights.
- The Awards are usually not protected against the dilutive effect of the start-up issuing further shares or Awards under this or another Employee Ownership plan, *i.e.*, there is no anti-dilution protection. The holders of Awards also have no say in any such capital increase. The only exception foreseen in many plans is that in certain cases of the company issuing new shares without the start-up receiving additional cash contributions in return (*e.g.*, capital increase of retained earnings) or there is no cash contribution beyond the shares' nominal value, the holders of Awards are made whole for the ensuing dilution.
- While Awards are usually hereditable (*vererblich*), they are not transferable (and may also not be pledged, *etc.*) without the company's prior consent. Free transferability would also turn Awards into a fungible security, which may have broader tax and regulatory consequences.
- There will be strict confidentiality rules.
- To avoid a potential insolvency of the company, any claims of the beneficiaries against the company under the Employee Ownership programs are usually subordinated to all present and future claims of the company's creditors.

V. ESOPs and VSOPs in Practice

Drafting and setting up a good Employee Ownership program is only a first step. In this Chapter, we want to discuss a couple of practical issues and questions that we frequently encounter when advising start-ups that are coming down the growth trajectory. Obviously, this can only be a summary of certain aspects and not a complete list and exhaustive description. Start-ups should work closely with their investors and trusted advisors when it comes to any of these or other issues (again, if this sounds like shameless self-promotion, trust your instincts).

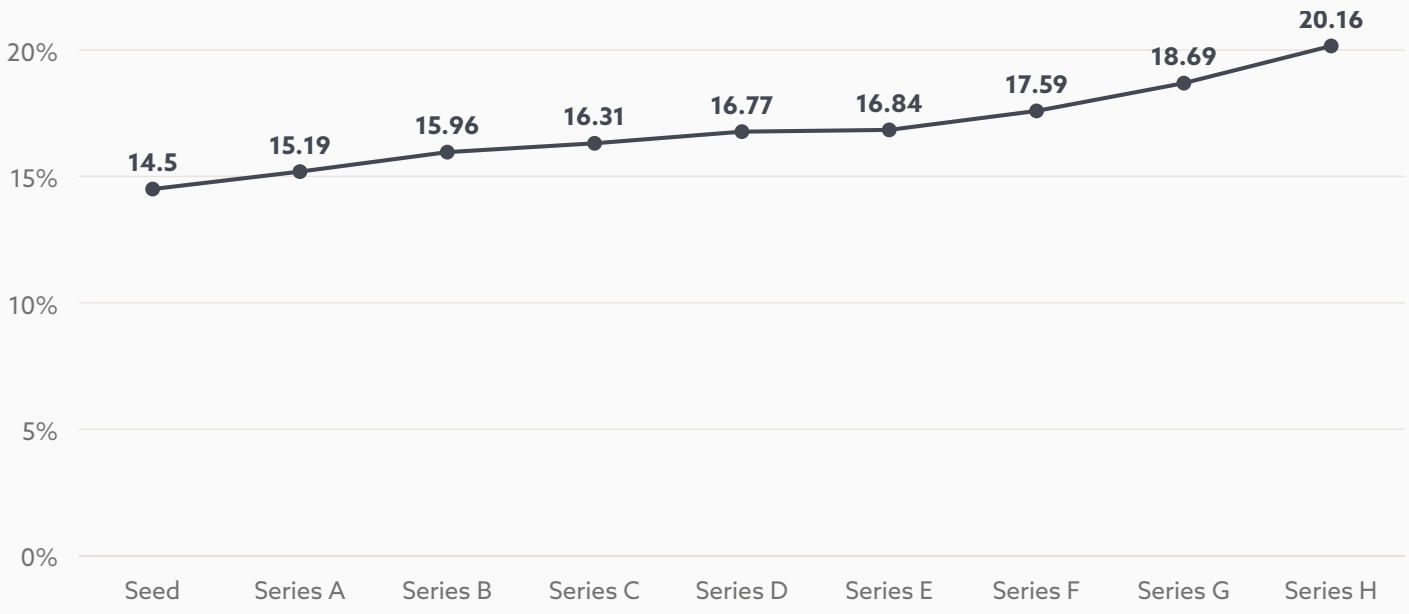
1. WHERE IT MATTERS – CONSIDERATIONS FOR THE SIZE OF THE POOL

1.1 Pool Size

While granting Awards under an Employee Ownership program typically requires no immediate cash outlay from the company (though social security contributions may apply for certain instruments like sec. 19a instruments), it does dilute the economic interests of existing shareholders. This fundamental trade-off raises a critical question: how large should the employee equity pool be, and what percentage of the company should be reserved for employee participation?

EMPLOYEE OPTION POOLS TYPICALLY COMPRISE <20% OF START-UP EQUITY

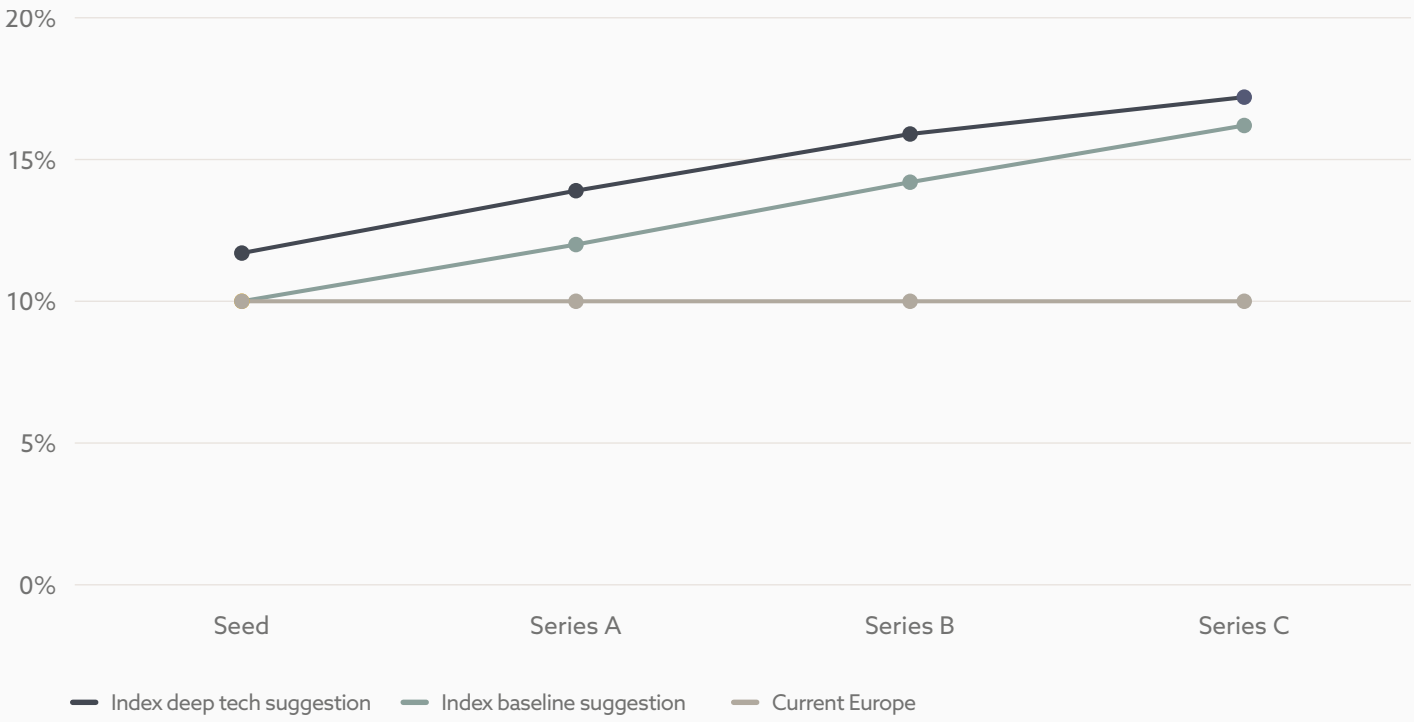
Median employee option pool plan size by stage | As of Oct 2024 (U.S. Companies)



Rather than remaining static throughout a company's life cycle, employee equity pools typically expand at each major financing round, with total pool size growing progressively as companies scale and their talent needs become more sophisticated. By the time a company reaches late-stage growth (Series H and beyond), the employee option pool can comprise as much as one-fifth of the company's fully diluted share count, and sometimes even more.

While significant variation exists across sectors and **European pools generally remain smaller** than their U.S. counterparts, examining transatlantic market data provides valuable insight into these dynamics. Current U.S. market analysis by *Carta* reveals that employee option pools begin at a median of 14.5% at the Seed stage and increase steadily with each subsequent financing round. The median pool size grows to 15.19% at Series A, 15.96% at Series B, 16.31% at Series C, and 16.77% at Series D. This upward trajectory continues through later stages: Series E companies allocate 16.84%, Series F reaches 17.59%, Series G climbs to 18.69%, and by Series H, the median option pool size reaches 20.16%.

INDEX VENTURE POOL SIZE SUGGESTIONS



We don't have similar robust data for the German market. In our experience, German start-up pool sizes are initially often smaller. While many venture capitalists still ask (at least in the Pre-Seed, Seed and early Series A stage) for an available pool of 10% of the company's fully-diluted share capital post their investment, we also see frequently smaller initial pools of around 8%. As a rule of thumb, then after each financing round, the Employee Ownership pool is typically topped back up to 8-10% of unallocated Awards to offset dilution, usually starting around late Series A and early Series B stages the requests drop to around 6% available Awards after the financing round.

For context, HSBC's 2025 VC Term Sheet Guide[2] analyzed over 500 term sheets executed in 2024, primarily covering UK financings. The analysis revealed that while a 10% option pool was the most prevalent size, appearing in 35% of deals, there was considerable variation across the market. Pool sizes under 5% represented the second most common category at 20% of analyzed term sheets, followed closely by pools sized between 11-15%, which accounted for 18% of transactions.

ORRICK DEAL FLOW INSIGHTS FROM EUROPE'S 2024 VENTURE CAPITAL DEALS

In the fifth edition of Orrick's unique Deal Flow survey[3], the team analyzed 375+ VC and growth equity deals completed by our clients across Europe in 2024. While the data for 2025 is still coming in and we will publish our findings for 2025 deals in early 2026, we want to share the most relevant insights we gained from the 2024 deal cohort when it comes to employee option pools.

Following a marked decrease in the number of financings in 2023 which included a top-up to the option pool (less than 40%), 2024 saw an increase to 57%. This is consistent with market trends and demonstrates increased market confidence, with hiring decisions shifting up the priority list of companies across all stages (particularly Seed through to Series B).

The top-up to the option pool is being included in the pre-money, avoiding dilution to incoming investors, in 79% of transactions which included an option pool top-up.

In 2021, we saw unallocated option pools being slightly higher (>10%) as companies were more bullish with their hiring agendas. In 2022 and continuing in 2023 and 2024, we saw the unallocated option pool percentages drop to 5-10%, which is more reflective of pre-2021 market conditions.

We saw the inclusion of an option pool top-up at later stages (Series B and beyond) increase significantly as compared to 2023, as founders moved away from the more frugal approach of the last few years and refocused on team growth.

However, founders and investors should be aware that these numbers can only provide a general guideline and the "right" size needs to be tailored to the company's needs and will—though investors might not always admit this openly—to some extent always reflect the bargaining power of the parties on the cap table. Founders need to understand that after pre-money valuation and the investment amount, the size of the pool is the third relevant economic factor that can have massive financial impact for the founders over the long haul. The founders should come prepared with a specific plan for what they will need to incentivize new hires and give top-up and refresher grants to existing employees over a period of around 18+ months after the financing round closes and start the assessment and negotiation of the "right" pool size from there.

In any case, the pool size should be reviewed regularly (on an annual basis seems appropriate in most cases) in conjunction with the company's hiring and growth plans. While, in theory, the size of the Employee Ownership pool should be designed to cover all of the potential talent needs over the next 18+ months, unexpected opportunities or challenges can impact hiring needs. Rapid company growth or the need to attract executives with substantial option expectations may require adjustments.

1.2 Increases of Pool Sizes and Investor Control Considerations

1.2.1 Valuation and Pool Size Increases

Employee Ownership programs play an important role in VC financing rounds as the size of the existing pool and any agreements about pool increases will be important factors for the start-up's fully-diluted pre-money valuation and thereby the dilution that the existing shareholders will suffer as a consequence of the financing round.

In a financing round, how many preferred shares the investors will get depends on the agreed fully-diluted pre-money valuation of the company. The pre-money valuation of a company is the valuation of the company that the existing shareholders and the new investor agree upon prior to the closing of the new financing round, *i.e.*, before the new investor puts any money into the company. That amount is divided by the fully-diluted number of shares in the company to determine the price per share of preferred stock that the investor will have to pay in the financing round, which in turn determines the number of preferred shares the investor will get.

2. https://www.hsbcinnovationbanking.com/en/resources/venture-capital-term-sheet-guide-2025.
3. The 2025 edition of Deal Flow can be downloaded here: https://www.orrick.com/dealflow.

The total number of issued shares, as well as the securities convertible into shares and Awards under Employee Ownership programs, is collectively usually referred to as a start-up's fully-diluted share number and this number is used to calculate the aforementioned price per new preferred share. The relationship is inversely proportional: a higher fully-diluted share count results in a lower per-share price, which in turn means investors receive more preferred shares for their investment, ultimately creating greater dilution for existing shareholders, particularly founders.

This is why when negotiating a financing round or comparing competing term sheets founders need to have a look at what the incoming investor requests about the pool of available unallocated Awards post financing. For the reasons set out above, only looking at the pre-money valuation offered by a potential investor might yield an incomplete picture. A higher request for an increase of the pool may ultimately make an offer less attractive for the existing shareholders.

Thus, the post-closing pool can be a critical negotiating point, and could be the link to obtaining a higher price per share if the parties agree on a smaller pool increase or—often more appropriate when the company actually needs more Awards for its hiring plans—that while the pool shall be increased, only a portion of such higher number of Awards shall be taken into account when calculating the fully-diluted share number. The latter means in economic terms that for the portion of the pool increase that is not reflected in the fully-diluted share number the new investors will share in the resulting dilution.

The table below provides an illustration of how Employee Ownership pool increases as part of a financing round can dilute the existing shareholder (we took this example from the very insightful and highly recommended publication *Rewarding Talent from Index Ventures*).

	Pre Series A	Post A-10% ESOP	Post A-15% ESOP	Post A-20% ESOP
Founders	65%	47%	43%	40%
Existing Investors	25%	18%	17%	15%
New Investors	0%	25%	25%	25%
ESOP-existing	10%	7%	7%	6%
ESOP-top up	-	3%	8%	14%
ESOP-Total	**10%**	**10%**	**15%**	**20%**
Total Ownership	100%	100%	100%	100%

Source: *Rewarding Talent* – A Guide to Stock Options for European entrepreneurs, Index Ventures

1.2.2 Employee Ownership and Investor Control

As part of the financing round, the parties will agree on certain protective provisions for the investors. This usually includes a catalogue of actions and measures that the company's management, *i.e.*, usually the founders, cannot take without prior consent by their investors, be it in form of an approving shareholders' resolution to be adopted with an investor majority or an approving resolution of the company's advisory board that needs to be adopted with a certain majority that often must include a certain number of investor-appointed members. Here, a balance needs to be found between the founders' wish to run "their" company as they see fit and the investors' legitimate interest to have some say in and control over certain particularly relevant measures.

We think that it is fair for investors (and founders alike) to have a say in the overall pool size as Awards will (economically) dilute all shareholders. However, in most cases we don't think that it is advisable for the start-up's advisory board (much less the shareholders' meeting…) to approve on each and every grant of Awards. With the exception of Award grants to founders and their relatives, the founders should be able to operate within a pre-approved allocation grid, *e.g.*, no individual allocation in excess of X Awards for employees of a certain category and no deviations from the standard vesting scheme and the determination of the strike price based on pre-defined criteria. As long as the founders stay within these boundaries, they should be free to grant Awards as hiring and retaining key talents is one of their most relevant jobs in the early (growth) phases of the company.

As *Ansgar Schleicher*, general partner at the German early-stage venture capital investor *TechVision*, observes: "Young founders sometimes give away too much, too early. We have the benchmarks they lack, so we ask the hard questions: How long will this hire actually stay? What value will they really create in a rapidly evolving startup and what are best strategies for option grants over time? Critical thinking beats generous impulses". His remark highlights why experienced investors bring valuable discipline to the table—protecting founders from overly generous equity decisions that could weaken long-term flexibility.

Striking the right balance between investor oversight and founder autonomy isn't just a legal formality. It's what keeps the company agile while protecting everyone's upside. A well-calibrated approval process for equity grants is more than tick a box for governance; it's a subtle art of trust, speed and keeping both sides hungry for success. The art lies in defining clear boundaries. Boards and investors need enough visibility to protect their interests, but not so much control that they slow down hiring or stifle the founders' ability to build a winning team. The best investors know when to lean in... and when to get out of the founders' way.

2. INITIAL ALLOCATIONS AND REFRESHER/TOP-UP GRANTS

2.1 Initial Allocations

The Employee Ownership compensation landscape has undergone significant transformation in recent years, fundamentally reshaping how companies approach initial Award allocations. Understanding these market shifts is essential for designing effective programs that successfully compete for talent while preserving valuable equity pool resources. We will add more data further below but want to share here one observation to illustrate this point: While overall pool sizes have declined somewhat from their 2021/2022 peaks, the reduction has been far more pronounced when looking at the initial grants for entry-level positions. End-of-2024 data for U.S. start-ups reveals that initial grants for newly hired junior employees remain 50% below their recent highs. In stark contrast, experienced professionals and specialty roles have largely avoided these reductions, with certain sectors actually seeing increased allocations for senior talent.

Companies must navigate a delicate balance: Employee Ownership allocations must be sufficient to attract and retain top talent, yet over-allocation risks unnecessary dilution of founder and investor stakes. This balancing act has become increasingly complex as market conditions have created divergent trends across different employee segments.

> "Initial allocations—especially in early stage companies - are still too often not well modeled to work over time. That is particularly true given longer liquidity cycles. Also remember that even experienced hires are unproven in your specific environment. So start smaller, then aggressively reward your rising stars instead of front loading. Understand your cap table and don't hire lawyers who can't."

Elias Börgmann-Dehin, General Counsel at Headline Ventures

2.1.1 Where We Are

Let's take a journey through recent market history to understand current trends and peek into the crystal ball for what the near future might hold.

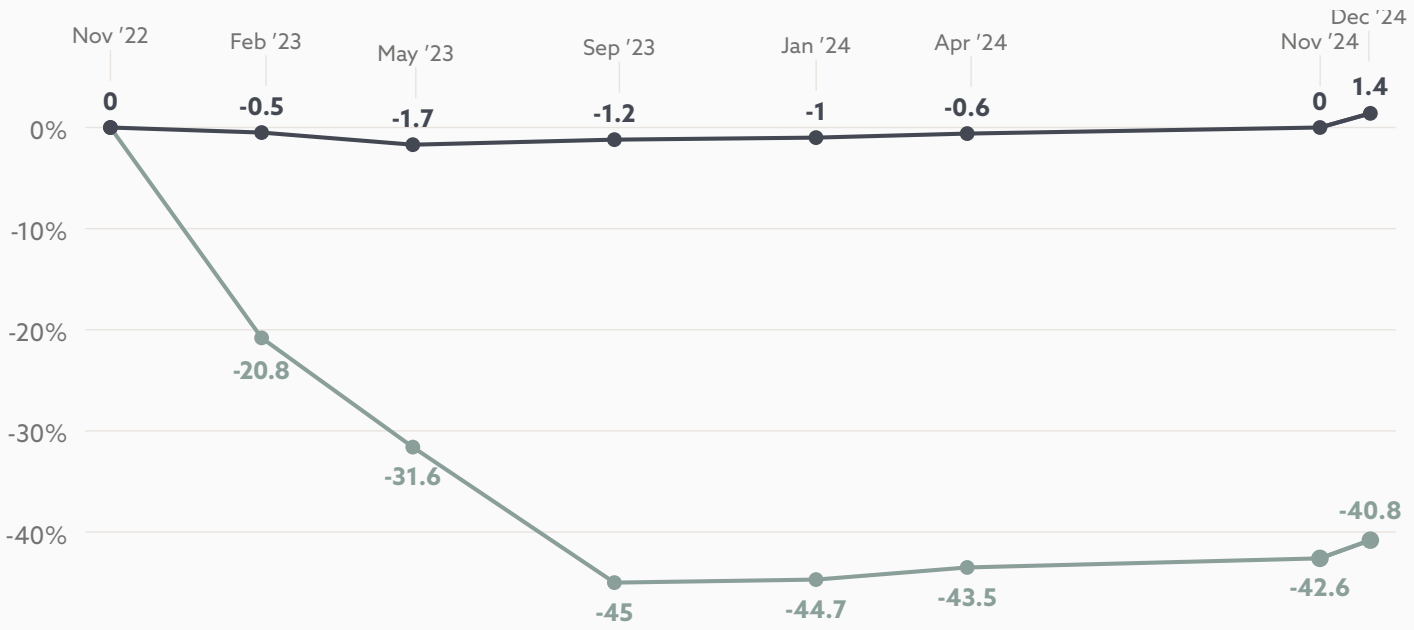
Over the past three years, Award grants for start-up employees have experienced dramatic shifts that mirror broader market realities. According to comprehensive market data, the median size of equity grants decreased sharply between late 2022 and late 2023, with median equity grant values dropping by approximately 45% from November 2022 to September 2023. This substantial decline reflected market uncertainty, macroeconomic pressures, rising interest rates and a general tightening of compensation packages across the start-up ecosystem as companies grappled with extended runway concerns and increasingly challenging fundraising environments.

Since Q3 2023, market data indicates the beginning of a recovery. This trend started in the United States and, based on our experience evaluating European deals at Orrick, has gradually spread to other start-up ecosystems. Equity grants have incrementally increased from their lowest point, though as of end-2024 data, they remain substantially below their November 2022 peak—a situation that, based on our observations, has not changed significantly through mid-2025.

The impact has been particularly pronounced for entry-level positions. As mentioned above, data from *Carta* indicates that today's average initial equity grant for junior employees remains approximately 50% lower than at the end of 2022. Despite recent improvements, most employees continue to receive considerably smaller equity grants than they would have received just three years ago—a reality that has forced both companies and employees to recalibrate their expectations around equity participation.

EQUITY PACKAGES AND SALARIES BOTH TRENDED UP IN 2024

Percentage change of salary and equity from Nov 2022 to Dec 2024



Source: © 2025 eShares, Inc. dba Carta, Inc. (Carta"). All rights reserved.

However, the data reveals substantial variation across sectors and seniority levels. Notably, certain AI and deep tech sectors have seen compensation packages that already match or even surpass levels from the funding boom of 2021 and early 2022. Additionally, executives and key employees have largely avoided substantial reductions in their allocations and top-up grants, reflecting the continued premium placed on senior talent.

This environment makes it more critical than ever for start-ups to adopt deliberate, data-driven approaches to equity allocations. Companies must carefully balance the realities of a more constrained market, the imperative to conserve equity pool resources for future growth, and the ongoing challenge of attracting and retaining top talent in an increasingly competitive landscape.

2.1.2 Factors Influencing the Initial Allocation

For lack of reliable German market data, let us again look at what we know about the situation in the United States as these numbers are generally at least directionally good proxies for the situation in Germany or at least give us some guidance on where developments might be heading.

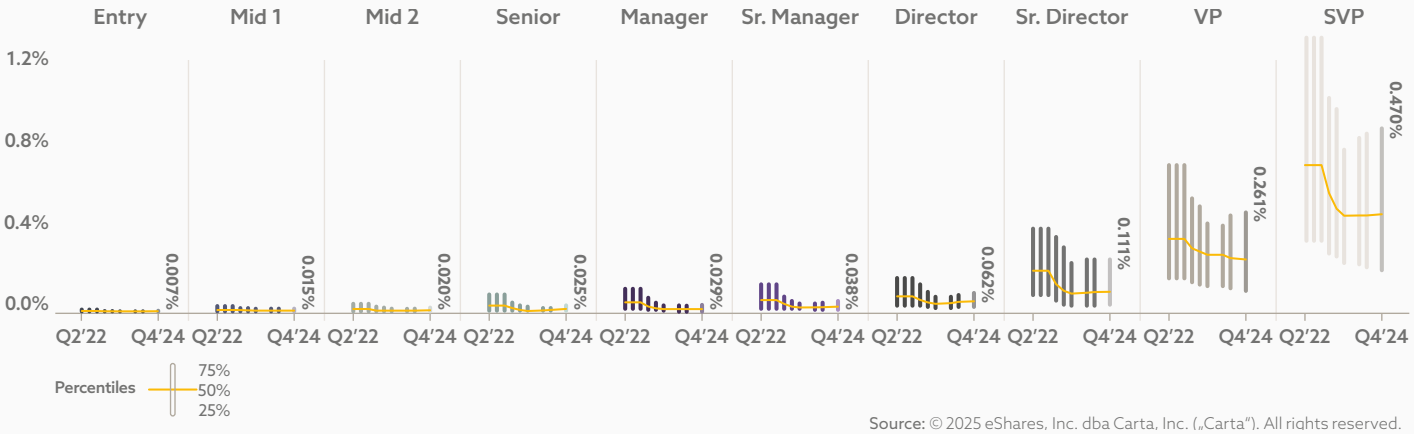
The Hierarchy of Equity – How Awards Scale With Responsibility: A core element of any Employee Ownership program is how equity is allocated across different roles and levels of seniority within the organization. Here, we can differentiate several dimensions that influence the initial grant sizes, notably seniority and function expertise, as well as the stage of the respective company. When interpreting the below numbers, it is also important to understand that in the United States, top-ups and refresher grants play a large role while in Germany we still observe somewhat larger (bulk) grants for early employees.

U.S. market data from Q4 2024 reveals a pronounced stepwise progression in grants as employees rise through the ranks in a typical start-up, demonstrating a steeply progressive structure where equity grants start small and ramp up significantly with each major career milestone.

- **Entry to Mid-level Progression:** At the entry level, the median equity grant is 0.007% of fully-diluted shares. This modest allocation reflects the broad-based approach of offering equity participation to all employees, but also acknowledges the limited relative impact these grants have at the earliest career stage. The philosophy here is inclusion over magnitude—ensuring everyone has skin in the game while recognizing that junior employees are primarily building skills and experience.
- As employees advance to "Mid 1" and "Mid 2" roles, the median equity grant increases to 0.015% and 0.020%, respectively. These increments are modest but meaningful, signaling growing responsibility and retention value. The progression reflects not just tenure but increased capability and impact on company outcomes.
- **Senior Individual Contributors and Early Management:** Senior-level employees receive a median equity grant of 0.025%, while those at the Manager level are typically granted 0.029%. At the Senior Manager level, the median allocation rises to 0.038%. This gradual progression ensures that employees who stay and grow with the company see their equity stake increase in tandem with their influence and impact on business outcomes.
- **The Leadership Leap:** The jump becomes more pronounced at the Director and Senior Director levels, with median equity grants of 0.062% and 0.111%, respectively. Here, equity transforms from primarily an incentive tool to a key component of total compensation and a critical lever for retention and strategic alignment. These roles typically involve significant decision-making authority and a direct impact on company direction.
- **Executive Compensation:** Executives see the largest grants by far, with Vice Presidents receiving a median of 0.261% and Senior Vice Presidents a substantial median of 0.470%. At these senior levels, equity grants become a central tool for aligning leadership with the long-term interests of shareholders and investors. These numbers reflect the high expectations placed on executives to drive company growth and deliver exit value, as well as the intensely competitive landscape for senior talent in start-ups.

MEDIAN EQUITY COMP FOR VPS IS 3.1X HIGHER THAN ENTRY LEVEL

Median salary and 4-year equity by role | $1B–$10B Companies | Q4 2022–Q4 2024 (U.S. Companies)



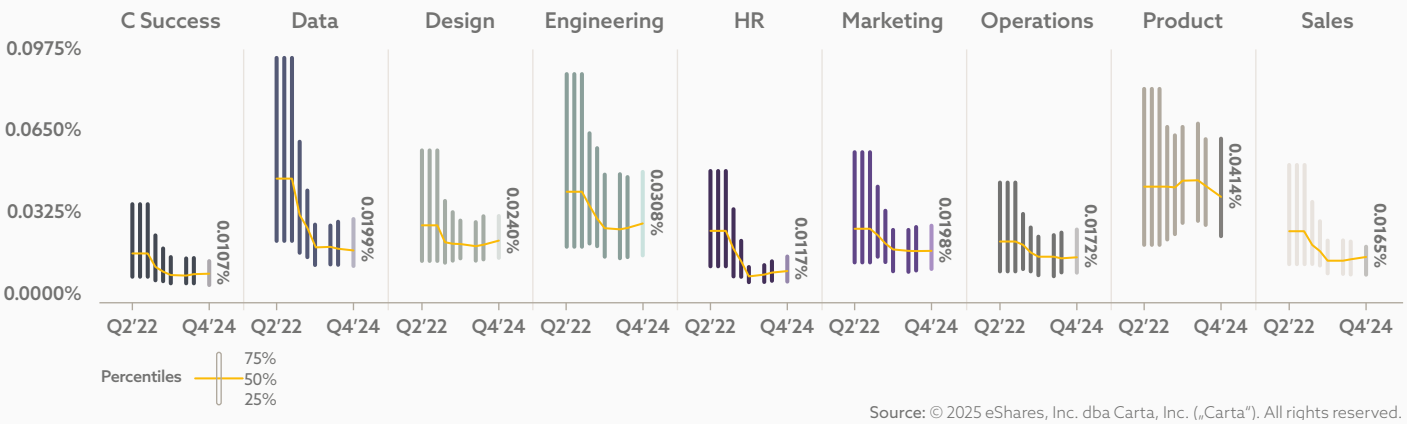
Function-based Equity Premiums – The Technical Talent Premium: While equity allocation by career level illustrates how grants scale as employees rise through the ranks, the data also reveals distinct patterns in how equity is distributed across different functional areas—patterns that reflect both market dynamics and strategic value creation priorities.

- **The Functional Hierarchy:** Based on median four-year equity grants for roles ranging from entry-level to senior manager, clear patterns emerge. Customer Success roles receive a median equity grant of 0.0107% of fully diluted shares, while HR employees typically receive 0.0117%. Sales roles are granted a median of 0.0165%, Operations roles 0.0172% and Marketing roles 0.0198%. Data roles are allocated 0.0199%, while Design employees receive 0.0240%.
- **The Technical Premium:** Engineering roles stand out with a median grant of 0.0308%, underscoring the fierce competition for technical talent and the strategic value attributed to these positions. However, Product roles receive the highest median grant among all functions at 0.0414%, reflecting the critical importance of product leadership in high-growth companies and the scarcity of exceptional product talent.
- **Understanding the Premium:** These numbers reveal that among employees from entry level to senior manager, technical and product-oriented roles—such as Engineering and Product—consistently receive higher equity grants than their peers in non-technical or support functions. At junior levels, technical roles command a 30-50% equity premium over non-technical roles. For example, while a typical entry-level HR, Marketing or Operations employee might receive an equity grant in the range of 0.01-0.02%, their peers in Engineering, Data or Product can expect grants ranging from approximately 0.02% to more than 0.04%.

This premium reflects multiple factors: the market's intense demand for technical and product talent, the direct impact these roles have on start-up value creation, the difficulty of replacing technical contributors, and the reality that technical employees often have more attractive alternatives in the job market. It also illustrates the importance for founders and shareholders to use function-specific benchmarks, not just level-based ones, when designing equity pools and individual grants.

AT JUNIOR JOB LEVELS, TECHNICAL ROLES HAVE A 30–50% PREMIUM

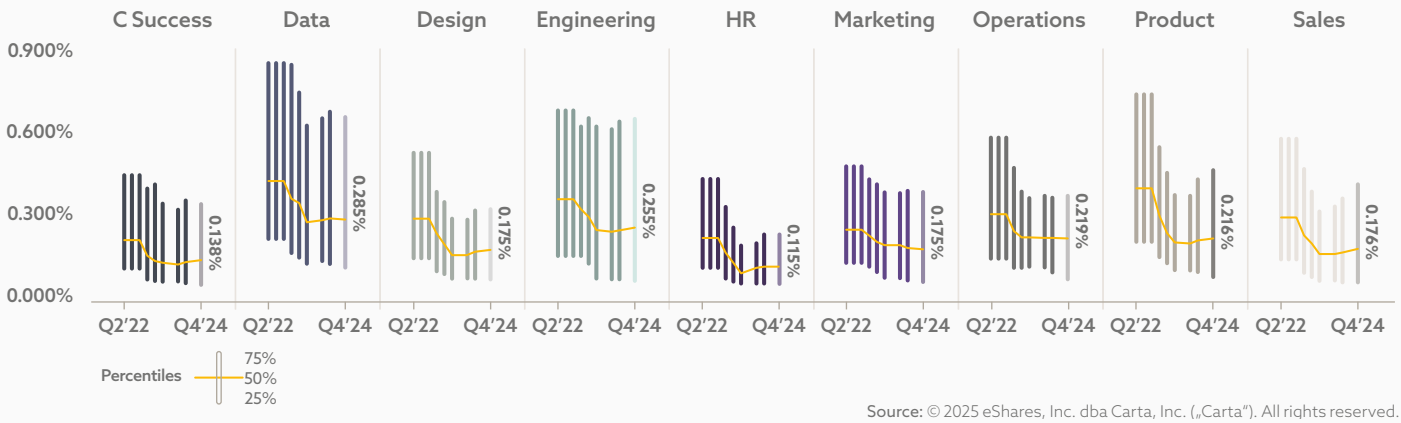
Median salary and 4-year equity by role | Entry to Sr Manager | $1M–$10B Companies | Q4 2022–Q4 2024 (U.S. Companies)



The Senior Leadership Paradox: Contrary to common assumptions, the data reveals a surprising pattern: higher-level jobs (Director to SVP) do not always receive substantially larger equity grants than lower levels. According to Q4 2024 data, the median four-year equity grants for Director to SVP roles, when broken out by function, often fall within a narrow band and in some cases are only marginally higher or even lower than those granted to junior and mid-level employees. This pattern reflects several realities: senior hires often join when company valuations are higher (making smaller percentages more valuable in absolute terms), executive compensation packages rely more heavily on cash components, and companies are increasingly focused on preserving equity for broader employee participation rather than concentrating it at the top.

AT HIGHER JOB LEVELS, MEDIAN SALARIES NEAR $200K IN ALL FUNCTIONS

Median salary and 4-year equity by role | Director to SVP | $1M–$10B Companies | Q4 2022–Q4 2024 (U.S. Companies)



Arguably the Biggest Driver – Company Stage: Company size and valuation stage significantly impact equity allocation patterns. The data shows that the absolute size of equity grants as a percentage of fully-diluted shares decreases as company valuation increases, but the dollar value of those grants rises substantially.

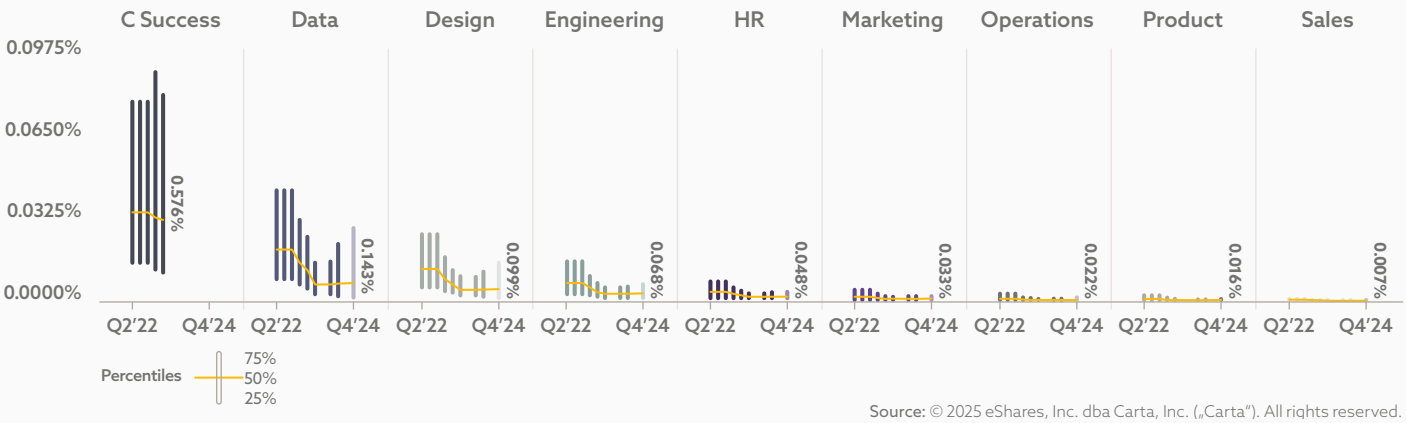
While the data presented above looked at technology companies of various sizes and stages, notably the very first employees can often demand higher allocation, and grants of around 1-2% for promising talent are not rare.

On the other end of the spectrum, in U.S. unicorn start-ups, the median four-year equity grant stands at 0.007%.

This reflects a typical pattern in the start-up ecosystem: as companies scale and their valuations grow, employees receive smaller slices of a much larger pie. The real-dollar value of their equity remains highly competitive and attractive, even as their ownership percentage shrinks. This dynamic creates interesting challenges for later-stage companies: they must communicate the value proposition of smaller percentage grants while competing with earlier-stage companies that can offer larger ownership stakes. In early-stage start-ups, it is not uncommon for the first employees to get allocations around 0.5% to 1% and for the first key hires sometimes even up to a few percentage points.

THE MEDIAN SALARY AT UNICORN START-UPS IS NORTH OF $170K

Median salary and 4-year equity by valuation size | $1B–$10B Companies | Q4 2022–Q4 2024 (U.S. Companies)



2.2 Refresher and Top-up Grants

The initial Award grant is just the beginning of an employee's equity journey. As companies mature and employees grow in their roles, a sophisticated approach to ongoing equity grants becomes essential for maintaining motivation, recognizing performance and preventing talent attrition.

2.2.1 Defining the Landscape

An equity refresher grant is an Award given to employees who have already received their original new-hire grant. The purpose is to continue incentivizing and rewarding employees as they move past the midpoint or full vesting of their initial grant, acknowledging that continued engagement and alignment are critical for sustained company growth. The term "top-up" grant is usually used synonymously. For those who like it more nuanced: "Top-up grants" usually summarizes the more purpose-driven and event-specific grants (*e.g.*, promotion-based, specific retention concerns, adjustment to shifting compensation benchmarks), while "refresher grants" describes the more systematic and ongoing grants that follow predictable patterns and are primarily designed to keep the beneficiaries' "equity stake" fresh for retention purposes.

As the amount of vested Awards increases over time, those that remain unvested become progressively less meaningful in incentivizing the employee to stay with the start-up. The psychological impact of this "golden handcuff erosion" cannot be understated—an employee with 75% of their original grant vested has significantly less financial incentive to remain than when they first joined.

Thus, companies should strategically consider refresher or top-up grants (sometimes also referred to as evergreen grants). These are additional Awards given on a more or less regular basis, typically beginning two to four years after an employee's initial grant, designed to maintain ongoing equity participation and retention power.

2.2.2 Timing of Refresher and Top-up Grants

Best practices for refresher and top-up grants have evolved substantially in recent years, as the importance of retention has become at least as critical as initial talent attraction. According to *Carta* data, between 2022-2024, about 20% of employees received a refresh grant at year one. By year two, nearly 50% of employees received at least one additional grant beyond their new hire grant.

This acceleration reflects several key insights:

- **Shortened Employee Tenure:** Most employees do not stay for a full four years, making earlier refreshers essential for retention (for details, see Chapter A.II.2.2.).
- **Competitive Pressure:** Companies that wait until year four to provide refreshers often lose key talent to competitors offering immediate equity upside.
- **Engagement Maintenance:** Even employees who plan to stay long-term are unlikely to remain fully engaged without renewed incentives.

The shift also acknowledges that the traditional four-year vesting cycle, inherited from public company practices dating back to the 1990s, may not align with the realities of start-up employment, where roles evolve rapidly and market conditions change frequently.

2.2.3 Different Strategic Rationales to Be Considered

Understanding when and why to provide refresher and top-up grants is crucial for designing an effective ongoing equity strategy:

Retention Considerations: The most obvious rationale is maintaining the "golden handcuff" effect as initial grants vest. This is particularly critical for key employees whose departure would significantly impact company operations or competitive position.

In this context, one also sometimes hears the argument that top-up grants can provide "compression relief". As companies hire more senior talent at higher equity levels, existing employees may find their positions compressed relative to new hires.

Performance Recognition: Exceptional performers deserve exceptional rewards. Top-up grants serve as powerful recognition tools for employees who consistently exceed expectations, deliver breakthrough results or demonstrate leadership beyond their formal role.

Role Evolution and Promotion: Employees naturally develop new skills, take on greater responsibilities and rise through the ranks. Top-up grants acknowledge this increased contribution and ensure their equity position reflects their current role and impact. In a similar fashion, when employees transition to more strategic roles or take on responsibilities in high-priority business areas, top-up grants can reflect the increased importance of their positions.

Market Competitiveness: Compensation benchmarks shift over time and an employee's initial grant may no longer be competitive. Top-up grants help companies stay competitive and prevent valuable employees from being poached.

2.2.4 Structuring Options for Refresher and Top-up Grants

The design of refresher programs significantly impacts their effectiveness. Different structures create distinct psychological and retention effects:

Tenure-based Refresher Grants: This is the most common and straightforward approach. Awards are granted when employees reach specific tenure milestones—typically when their new-hire grant is at least halfway vested or fully vested. Some companies issue these at regular intervals, such as annually or every four years.

- **Advantages:** This approach is simple to communicate and understand and it is easy to forecast its impact on the Award pool. It is also not particularly complex from an administrative point of view.
- **Challenges:** A pure tenure-based refresher can create pronounced "cliff" effects after four years—meaning employees face a sudden drop in their unvested equity holdings once their original grant fully vests, potentially creating some incentive to leave the company at that point since they have little remaining equity upside to forfeit. It might also not be perceived as particularly fair as it doesn't differentiate the refresher grants based on performance and employees can interpret it as rewarding tenure over actual contribution.

The Boxcar Grant Method: To mitigate cliff effects, many companies employ the boxcar grant method. A larger grant is given partway through the initial vesting period (typically at year two or three), but vesting of this new grant only begins after the original grant has fully vested (after year four). The boxcar grant then vests over a relatively short period, such as one year.

- **Advantages:** This method avoids overlapping vesting periods and provides a seamless transition that maintains continuous equity incentives for employees. It reduces administrative complexity compared to multiple overlapping grants and creates strong retention incentives through year five when the boxcar grant completes vesting.
- **Implementation Considerations:** The boxcar method requires careful timing to maximize retention impact and prevent employees from leaving during the gap period. It may create confusion about employees' total equity position since they hold grants with different vesting schedules. Clear communication about vesting schedules and total equity holdings becomes essential for employee understanding and satisfaction.

And why "boxcar"? The method gets its name from the visual appearance of the vesting schedule when plotted on a graph. Here's why: When you chart the unvested equity over time, it creates a pattern that resembles railroad boxcars lined up on a track. The original grant creates one "boxcar" that decreases in height as it vests over four years. Then there's a gap (like the space between train cars), followed by another "boxcar" representing the second grant that vests over a shorter period.

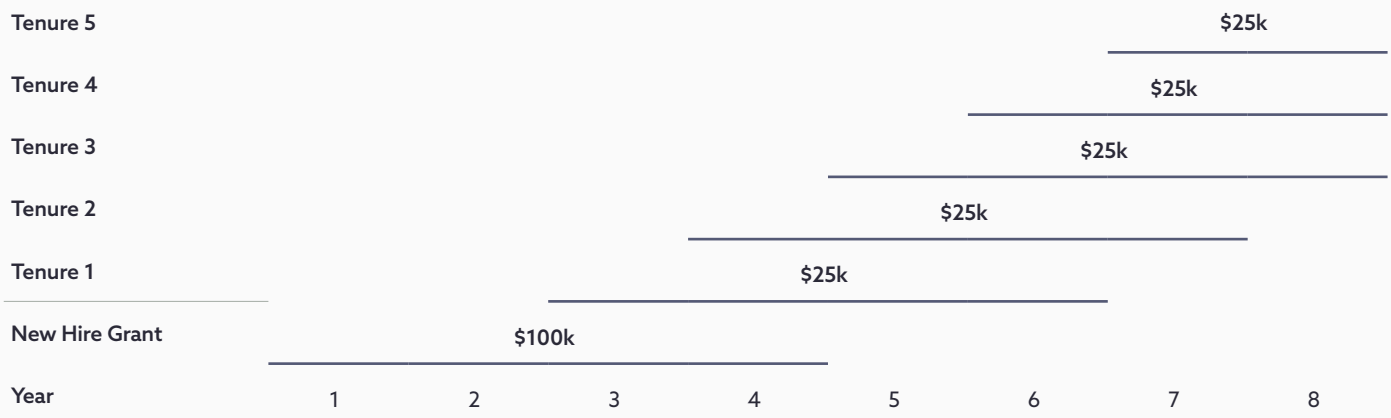
Traditional Annual Refresher Grants: Employees receive smaller, more frequent grants—typically annually or at each performance review cycle. These grants usually start vesting immediately and may vest over one to four years, layering on top of existing grants.

- **Advantages:** This approach simplifies equity budgeting by creating predictable annual allocation requirements that can be planned and forecasted. It provides employees with regular, predictable equity Awards that maintain ongoing motivation and engagement. The annual cycle allows for performance-based differentiation in grant sizing while maintaining consistent retention pressure through continuous unvested equity holdings.
- **Challenges:** Annual refreshers can intensify "year four drop" effects since employees may never accumulate more unvested equity than in their fourth year, potentially reducing incentives to stay beyond that point. This method creates overlapping vesting schedules that can be difficult for employees to understand and for companies to administer. It may lead to equity inflation if grant sizes aren't carefully managed over time, and it requires more administrative overhead to track multiple overlapping grants for each employee.

TENURE GRANT APPROACH

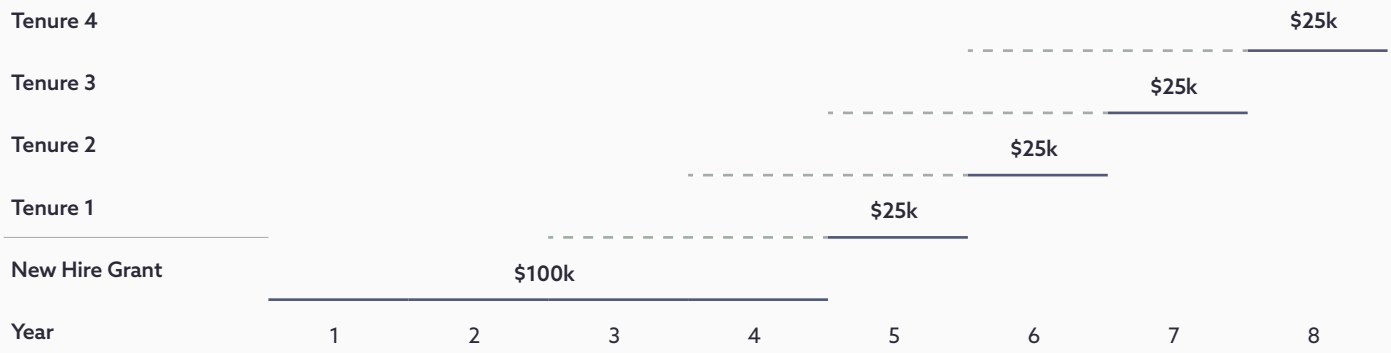
There are two types of vesting schedules.

Traditional: Grant vests over four years on top of any other grants



Pro: Easy to communicate and immediate reward
Cons: Exacerbates year four drop

Boxcar: Grant vests over a 12-month period after the original new hire grant is finished vesting, but is granted years in advance



Pro: Solves for the year four drop
Cons: More difficult to communicate

Performance-based Refresher Grants: These Awards are tied to individual performance, achievement of specific targets, or company milestones. They're typically awarded during regular review cycles and can vest over one to four years.

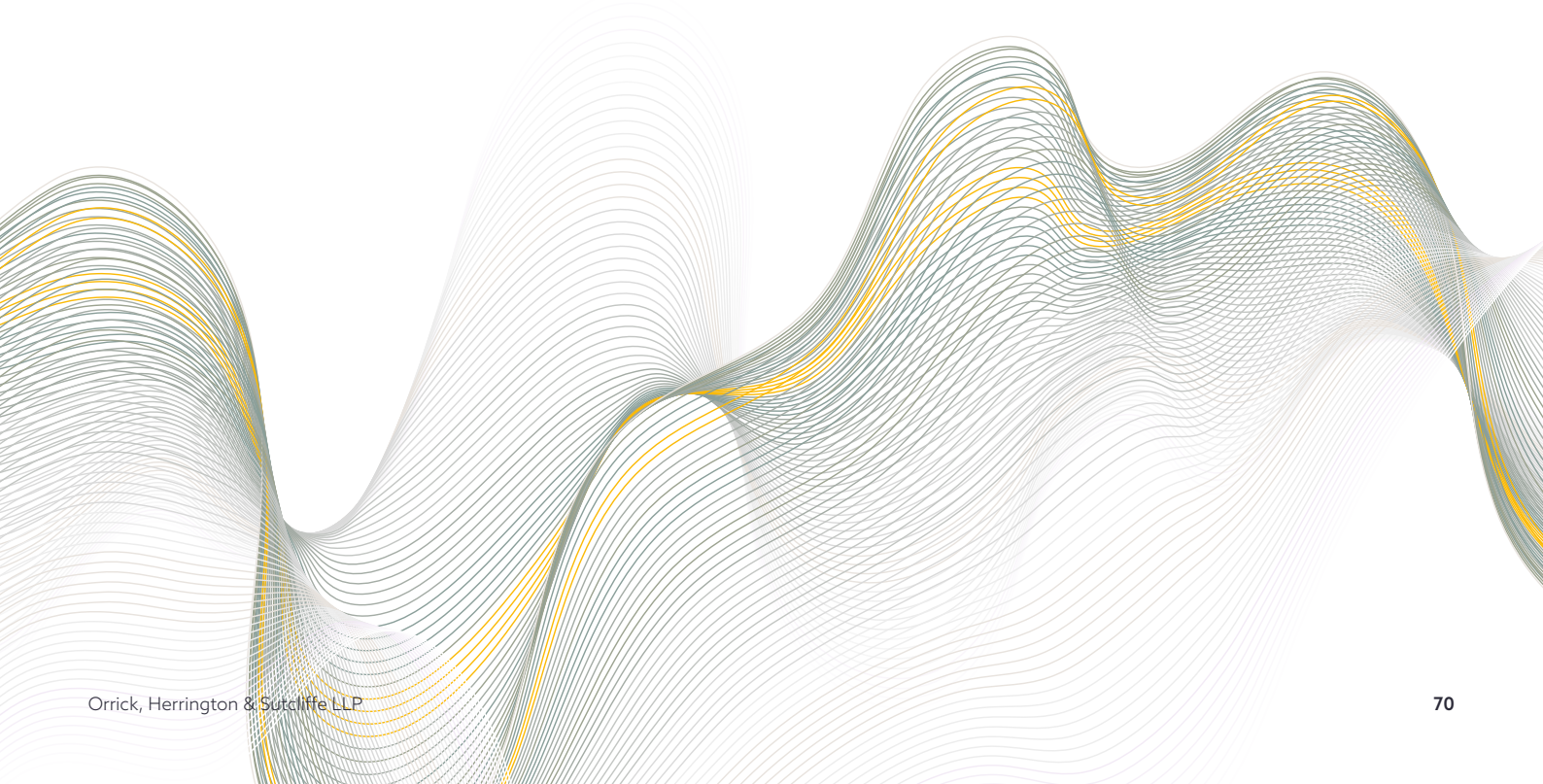
- **Advantage:** Performance-based refreshers directly reward contribution and results, creating a clear link between equity participation and individual impact. They reinforce a performance-driven culture by demonstrating that exceptional work leads to exceptional rewards. This approach allows for significant differentiation between employees based on their contributions and can be tied to broader company success metrics to align individual and organizational goals.
- **Challenges:** This approach requires robust performance measurement systems to ensure fair and accurate assessment of employee contributions. It may create internal competition or resentment among team members if not carefully managed, particularly when criteria are perceived as subjective or unfair. Performance-based grants make it difficult to predict the impact on the equity pool since the number and size of grants depend on actual performance outcomes. The system needs clear, objective criteria to avoid bias and ensure that decisions are defensible and consistent across the organization.

PERFORMANCE GRANTS (4-YEAR VEST)

High performing employees receive additional equity incentive grants on top of the base-rate tenure grants. Grant will be around 20% of new hire grant depending on ratings distribution.

Performance Grant 1				**$20k**				
New Hire Grant	**$100k**							
Year	1	2	3	4	5	6	7	8
Total Value at Grant	$25k	$25k	$30k	$30k	$5k	$5k	–	–
Total Value w/Growth*	$25k	$38k	$61k	$92k	$11k	$17k	–	–

* Assumes 50% annual growth



Promotion-based Top-up Grants: These grants ensure that promoted employees' total equity aligns with market compensation for their new position. The typical calculation compares what a new hire would receive for the new role and subtracts what the promoted employee already holds.

- **Advantages:** Promotion-based top-ups maintain internal equity and fairness by ensuring that long-tenured employees aren't disadvantaged compared to external hires at similar levels. They recognize career progression and reward employees for their growth and increased responsibilities within the organization. This approach prevents equity compression versus external hires and reinforces promotion as meaningful advancement that comes with tangible financial benefits.
- **Challenges:** This method requires accurate and current market data for benchmarking to ensure appropriate grant sizing, which can be costly and time-consuming to obtain. It may create expectations among employees for automatic equity grants with any promotion, regardless of performance or company circumstances. The calculation needs to carefully account for the difference between vested and unvested holdings to avoid over- or under-compensating promoted employees. Companies should also consider tenure and performance factors when determining appropriate top-up amounts rather than relying solely on mechanical calculations.

PROMOTION GRANTS

Make the grant equal to the difference between the midpoints of the level the employee is moving from and the level they're moving to ensure employees receive additional equity.

L1 grant midpoint	$100k
L2 grant midpoint	$200k
Role change grant (L1>L2)	**$100k**

Time of role change

Role Change Grant: L2				**$100k**				
New Hire Grant: L1			**$100k**					
Year	1	2	3	4	5	6	7	8
Total Value at Grant	$25k	$25k	$50k	$50k	$25k	$25k	–	–
Total Value w/Growth*	$25k	$38k	$81k	$122k	$56k	$84k	–	–

* Assumes 50% annual growth

2.2.5 Sizing and Timing Considerations

The 30% "Rule": In the U.S. practice, one often hears as guidance that refresher grants typically represent about 30% of what a new hire would receive if hired into that role at the time of the refresh. However, this percentage varies significantly based on several factors:

- **Grant Type Variations:** In accordance with the different rationales for top-up and refresher grants discussed above, in practice we see quite some variation in the size of such grants. Performance-based grants typically range from 25-50% of new hire equivalent, with the higher end reserved for exceptional performers who significantly exceed expectations. Promotion grants usually represent 50-100% of the difference between the employee's current total equity position and what a new hire would receive at their new level. Retention grants, designed primarily to prevent departures, typically range from 20-40% of new hire equivalent since they focus on maintaining golden handcuffs rather than rewarding performance. Annual refreshers are generally smaller at 15-25% of new hire equivalent because they are granted more frequently and are designed to maintain consistent equity participation over time.
- **Seniority Adjustments:** Senior roles often receive proportionally larger refreshers ranging from 35-50% of new hire equivalent due to their higher impact on company success and the increased difficulty and cost of replacing experienced leadership talent. Junior roles may receive smaller percentages ranging from 20-30% of new hire equivalent, but companies often compensate for this by providing more frequent grants to maintain engagement and recognize rapid skill development typical at earlier career stages.

The Acceleration of Refresh Timing: Over the last years and in line with the tendency towards shorter tours of duty for employees in many tech hotbeds, one could observe shifts in the timing of refresher grants toward earlier intervention. About a fifth of all beneficiaries have received some form of top-up or refresher grant by the end of year one with that number rising to about half of all beneficiaries by the end of year two, marking halftime of the usual four-year vesting period. This acceleration reflects the growing understanding that waiting until original grants are fully vested can be too late—key employees may already be exploring alternatives by that point.

IMPLEMENTATION BEST PRACTICES

The most successful top-up and refresher programs feel systematic rather than arbitrary, generous but sustainable, and fair while recognizing individual contributions. They reinforce company values and strategic priorities while maintaining the long-term viability of the Employee Ownership program.

Below are some best practices that start-ups deploy when it comes to implementing top-up and refresher programs as well as some common pitfalls:

Do's

- **Budget Planning:** Establish annual budgets for refresher and top-up grants as a percentage of total equity pool (typically 8-15% annually depending on the plans for new hires) to prevent ad-hoc decisions from depleting resources.
- **Committee Governance:** Create equity committees comprising HR, finance and senior leadership to ensure consistent decision-making and to prevent favoritism.
- **Clear Criteria:** Develop transparent guidelines for top-up and refresher eligibility, sizing and timing to manage expectations and ensure fairness. At the same time, employees should understand that refreshers aren't automatic entitlements but are based on performance, market conditions and company success.

Don'ts

- **Over-granting:** Resist solving every retention challenge with equity—sometimes other compensation or development opportunities are more appropriate.
- **Inconsistency:** Establish clear criteria and adhere to them to avoid perceptions of unfairness and equity inflation.
- **Poor Communication:** Lack of transparency about refresher processes breeds resentment and speculation.
- **Pool Depletion:** Monitor cumulative impact on equity pools—today's generous refreshers might constrain tomorrow's hiring ability.

3. INTERNATIONAL ASPECTS

3.1 German Programs for International (in Particular, U.S.) Beneficiaries

German start-ups frequently seek to hire talent irrespective of location or pursue an internationalization strategy that requires them to hire people on the ground. Often, these international hires will expect some form of employee participation. So the question arises whether the German start-up can use its German Employee Ownership program also for such international hires.

While the answer is "generally, yes", from a practical perspective, German start-ups should pay particular attention when using a typical German market VSOP to grant Awards to employees who are tax resident in certain jurisdictions, notably the United States. Using a German VSOP or ESOP in the United States is doable but usually requires attention to the following two matters:

U.S. Tax Issues: We will save you the opaque details of U.S. tax rules here, but suffice it to say that the issuance of Awards under a VSOP or an ESOP (that is, when the German-style ESOP does not constitute a U.S.-style ESOP) to U.S. beneficiaries (meant as U.S. taxpayers) may result in adverse tax consequences or result in a taxable event upon meeting any time-based vesting requirement (!) unless there is an additional real risk of forfeiture for the employee. Why is this problematic? Well, German VSOPs usually do not provide for an expiration date for the Awards granted thereunder (or they foresee a very long term of 10+ years). If the VSOP or ESOP includes in its definition of exit/liquidity event also an IPO or other public listing (as it is commonly the case), then in order to comply with U.S. tax rules, it is mandatory that the plan foresees a time limitation for the Awards that constitutes an additional risk of forfeiture. The U.S. market standard would be seven years after the grant. This means that the Employee Ownership program must foresee that the Awards will expire without any compensation if no exit/liquidity event will occur within such period of usually seven years after the grant of the respective Award. A potential alternative would be to take the IPO out of the list of trigger events for the Employee Ownership (though for obvious reasons, the beneficiaries will not like that approach though there are potential economic substitutes available, *e.g.*, IPO bonus arrangements, but it can be difficult to structure those arrangements under U.S. tax rules). Alternatively, the Awards can be structured so that the strike price is not less than fair value of a share on the date of grant, but that requires a third party independent valuation that is supportable for U.S. tax purposes to shift the burden to the U.S. tax authority to have the burden of challenging the fair value determination.

Against this background, German start-ups should obtain proper legal and tax advice from counsel with experience on both sides of the pond before issuing Awards to a U.S. tax resident or risk getting in trouble with the IRS or inadvertently triggering adverse tax consequences for the employees. If this sounds like shameless self-promotion, we suggest you trust your instincts.

U.S. Securities Rules: The other aspect that should be checked before issuing Awards to U.S. beneficiaries is whether such issuance would comply with U.S. securities laws. Some Awards, including arguably those issued under a typical German market VSOP, can qualify as "securities" within the meaning of U.S. law, both on a federal and state level. The good news is that often relatively broad exemptions from registration requirements will be available for Employee Ownership programs (though certain disclosure requirements might kick in once certain thresholds are exceeded) but that also depends on the state in which the respective U.S. beneficiary resides. In addition, in some states such as New York, filing rules may apply though they should not be particularly burdensome to comply with.

3.2 U.S. Programs and Sec. 19a EStG – The Group Privilege

After having looked at the use of German market Employee Ownership plans internationally, let us now see if it is possible to use an international Employee Ownership program for beneficiaries in Germany and benefit from sec. 19a EStG at the same time.

For German founders and investors, this question is particularly relevant for German start-ups that have been set up with a U.S. holding entity (usually a Delaware C-Corp) as holding entity for a wholly-owned German operating entity. If the start-up is brand new, this structure can be set up from scratch and existing German start-ups can get into such a structure through the famous "Delaware flip". We have dedicated an entire issue of the OLNS to such structures[4].

For the purposes of this Guide, the interesting question is if one can set up a typical Silicon Valley-style ESOP[5] at the level of the U.S. holding entity and issue Awards thereunder to the beneficiaries of the German subsidiary in a way that the German beneficiaries can benefit from the tax privileges of sec. 19a EStG. A U.S.-style ESOP doesn't face the governance challenges of a share-based ESOP in a German GmbH and, unlike a PPR, doesn't require explanation as beneficiaries in most international hotbeds will be relatively familiar with the workings of a U.S.-style ESOP. Issuing share options or shares in a Delaware C-Corp requires no notarization and wouldn't create any material governance issues for the company or make future financing rounds more complex.

4. See OLNS#7—Flip it Right: U.S. Holding Structures for German Start-ups, the Guide can be downloaded here: https://www.orrick.com/en/Insights/2024/06/Orrick-Legal-Ninja-Series-OLNS-7-Flip-it-Right.
5. For a summary of typical U.S. ESOP see pp. 63-67 of OLNS#7.

Under the old version of sec. 19a EStG, this would not have been possible as it required sec. 19a instruments from the entity employing the respective beneficiary, *i.e.*, shares in the GmbH or a PPR issued by the GmbH.

Under the revised and currently applicable version of sec. 19a EStG, there is now a group privilege. With effect as of January 1, 2024, sec. 19a EStG is available to the German tax-resident employees of the subsidiaries when they receive Awards under an ESOP set up on a group level. The group privilege has two prerequisites:

- To claim the group privilege, the respective group must meet the criteria of a group in terms of sec. 18 of the German Stock Corporation Act (*Aktiengesetz*), *i.e.*, either qualify as (i) a subordinate group comprising a controlling entity and one or more dependent entities, all under unified management, or (ii) a coordinated group where the entities are managed together but do not depend on one another.
- The respective group may—on a consolidated basis—not exceed the thresholds that apply in a single-tier structure for the employer issuing the shares.

The last bullet can become problematic: For the group privilege to apply, the requirements for sec. 19a EStG need to be fulfilled by the whole group (all of its entities combined), not just the company issuing the shares. The legislator considers these limitations necessary to prevent unintended tax benefits for employees of large corporations by shifting business units into smaller subsidiaries and then granting parent company shares under favorable tax treatment. In practice, this means that even if only one group company exceeds the SME thresholds or maximum age, the entire group is excluded from the privilege.

While the text of sec. 19a EStG applies to shares issued by parent companies or group entities without any requirement of such issuing entity to be a German entity, in early 2025, there was some discussion whether the tax authorities would accept such foreign entities. Some claimed that at least the lower-level tax authorities in Berlin took the position that under the group privilege, only German entities could be considered as permissible issuing entities.

As a consequence, we at Orrick reached out to the tax administrations in various German Federal States and we received on various occasions the indication that foreign entities comparable to a German stock corporation should be entitled to claim the group privilege. We agree. The wording of the provision does not provide any indication of such a restrictive interpretation. A restrictive interpretation would also contradict the intent of the revised provision. The law focuses on economic participation rather than the legal domicile of the issuer. As a consequence, entities in the legal form of a Delaware C-Corp or a UK plc. (for EU companies, the situation may be slightly better yet is more complex) should be entitled to claim the group privilege.

That being said, over the next years, there will still be some practical challenges to overcome. For example, there is some valuation complexity. US entity shares may be harder to value for German tax purposes, in particular the typical "409a valuation" that many service providers in the United States offer for a small fee does not suffice for German tax purposes without some modification and German tax authorities may require additional documentation and proof.

In any case, such trans-Atlantic structures require coordination between German and U.S. tax advisors and proper documentation. While sec. 19a EStG doesn't categorically exclude U.S. entity shares, the practical implementation for German employees of the subsidiaries of U.S. companies is more complex and uncertain than for purely German structures. The "group privilege" concept exists, but its application to U.S./German structures requires careful analysis and often wage tax clearances are advisable to ensure compliance and effectiveness.

For German employees, receiving restricted stock (*i.e.*, actual shares, possibly with vesting or forfeiture provisions) is usually more tax-advantageous than receiving stock options under a U.S.-style ESOP. The reason is the timing of taxation under sec. 19a EStG: Wage tax is assessed and deferred based on the value at the time the employee actually receives the shares. If restricted stock is granted early, when the company's value is still low, wage tax will ultimately only be due on this lower value, and any future appreciation will be taxed at the lower capital gains rate. In contrast, if stock options are granted, sec. 19a EStG only applies when the option is exercised and the shares are actually received—that might often be close to an exit event, when the company's value is much higher. This means wage tax would then be due on the full, higher value, negating the main benefit of sec. 19a EStG. If stock options have already been granted to German employees, it may be advisable to explore whether these options can be restructured to allow for early exercise, so that at least some of the sec. 19a EStG benefits can still be achieved before a significant increase in company valuation occurs.

3.3 German Programs and PEOs

When seeking talent abroad, many start-ups rely on the services of so-called "professional employer organizations" ("PEO" for short). The PEO is an outsourcing service provider. Drawn with a broad brush, if a start-up identifies a suitable talent abroad, such talent will be hired by the PEO and then made available to the start-up. The PEO will be the employer of record and will process payroll, withhold and pay wage taxes, maintain workers' compensation coverage, provide access to employee benefit programs, offer human resources guidance and handle other HR tasks. As compensation, the start-up pays a certain fee to the PEO.

Given that today the war for talent is fought in an increasingly international arena and many fast-growing start-ups rely—at least for some time—on PEOs when onboarding talent overseas, the question arises whether the talent that is engaged through a PEO can receive Awards under the start-up's Employee Ownership programs.

One possibility would be for the PEO to enter into an agreement with the employee that economically mirrors the Employee Ownership programs and to request the company to indemnify it from any ensuring liabilities in addition to the fee it will charge for its services. However, this will certainly make life more complex for the PEO and according to our experiences, PEOs are often reluctant to agree to this approach. In this case, the start-up itself will grant the Awards to the respective beneficiary although when using a PEO, the start-up will normally not have any direct contractual relationships with the respective individual. Any such direct grant would need to be reviewed under the applicable local laws. In addition, the company needs to keep in mind that the wording of most standard Employee Ownership programs will not always be appropriate for talent that is engaged via a PEO. For example, the typical leaver provisions refer to the employment relationship or service contract between the beneficiary and the company. As there is no such employment or service agreement in case of a beneficiary that comes through a PEO, the respective clauses would need to be amended (which can be done in the respective allocation letter).

4. ESOP/VSOP AND M&A PROCESSES

4.1 The Interests Involved

In many M&A processes, the fact that a company is up for sale will at some point inevitably leak. There are usually too many people involved to keep an ongoing acquisition process secret for long. Founders need to have a straight communication plan and how to manage their workforce and the ensuing uncertainty among their employees. At some point, employees will start wondering what will be in for them under the Employee Ownership programs and what will come thereafter, *i.e.*, what will employee incentivization look like in the post-merger integration phase.

A target company's Employee Ownership plan can be a crucial factor when preparing and implementing a sale. Sellers must understand the vesting schedules, conditions for exit and any acceleration provisions that might be triggered by the M&A transaction. In particular, it is important to clarify whether unvested shares or options will accelerate by reason of the deal closing (single trigger) or only if employment is terminated without cause or by the employee for good reason within a defined period after closing (double trigger). Ensuring that employees perceive the payout as fair is essential to maintaining morale and avoiding disputes. The structure of the payout—whether immediate or deferred—can also impact employee retention after the exit. For a discussion of the different approaches to accelerated vesting please see Chapter A.IV.3.3.

Sellers also need to consider how the participation programs will integrate into the buyer's structure and what incentives may be necessary to retain key employees.

Clear communication with employees about how the exit will affect their participation plan is crucial. This includes information on timing, payout modalities, treatment of unvested Awards and potential new offers from the buyer. In some cases, it may be appropriate to offer alternative or additional exit incentives, especially if key employees have only a small (vested) allocation or if investor liquidation preferences are likely to limit payouts under the Employee Ownership program.

The buyer will also be interested in understanding the existing Employee Ownership programs for a variety of reasons:

- The financial obligations under existing Employee Ownership programs will affect the target company's valuation. In a VSOP, for example, beneficiaries hold cash compensation claims against the company that the buyer must account for—unless shareholders agree to indemnify or assume these obligations at closing. The same applies to PPRs that mirror VSOP structures and entitle beneficiaries to payments linked to founders' exit proceeds. Typically, shareholders either assume these obligations or indemnify the company. If, instead, PPRs are sold as part of the exit, the parties must agree on whether the buyer takes them over or how they are settled.
- The buyer will also want to gauge how much the target's key employees will receive from the transaction. This helps shape retention strategies, especially for financial sponsors like private equity funds that often invite key employees to reinvest or roll part of their proceeds into a new program. As discussed, single-trigger accelerations upon a sale can prove problematic for founders and investors.
- Finally, existing Employee Ownership programs may not align with the buyer's compensation philosophy. This misalignment can complicate integration, as employees' prior incentives often form their future expectations. The integration plan should therefore include a clear strategy to harmonize incentive structures post-acquisition.

Unless the start-up has reached a very mature stage with an established brand, well-oiled processes and governance, and has institutionalized most of its know-how, any experienced buyer will understand that to preserve the company's value, it will need to secure the ongoing services of key team members. Any potential buyer will be concerned about seeing the value of the company they are about to acquire literally walk out the door when handing over potentially life-changing amounts of cash to executives and then trying to formulate retention packages that are sufficient to actually get them to remain in their jobs through the sometimes difficult period of post-merger integration, a time when these employees may have new bosses and uncomfortable new levels of corporate bureaucracy. All considerations that might negatively affect the start-up's valuation and delay the acquisition process.

To avoid disputes about payout amounts and mechanisms, it is advisable to implement settlement and retention agreements with key employees. This can include rolling over a portion of exit proceeds into new incentive plans or other retention elements, ensuring a smooth transition and continued engagement of critical talent.

4.2 Settling the Employee Ownership Program in Case of an Exit

The procedures for settling Employee Ownership programs in the event of an M&A transaction are explained in detail in our Guide OLNS#13—M&A in German Tech[6], so we will limit ourselves to a brief overview here.

While the treatment of equity instruments issued under an ESOP, in particular growth shares and sec. 19a instruments, are relatively straight-forward, there are basically two options to deal with a VSOP.

Growth Shares: Growth shares participate in exit or liquidation proceeds only above a defined hurdle. In other words, they receive value only once other shareholders have obtained a specified minimum amount—economically similar to a negative liquidation preference. The share purchase agreement typically defines a uniform purchase price per share, regardless of how sellers internally allocate proceeds under positive or negative liquidation preferences. After signing, sellers usually instruct the buyer to distribute proceeds according to these internal arrangements. As a result, holders of ordinary shares (or a sub-group) first receive their *pro rata* share of the hurdle amount, while growth shares participate only in proceeds exceeding that threshold.

German tax law shall recognize the limitation of the proceeds participation of the growth shares and subject the proceeds allocated to the growth shares to capital gains taxation. Likewise, the redistributed hurdle amount shall also be subject to capital gains taxation for the shareholders that stand to benefit from such reallocation.

6. See OLNS#13—M&A in German Tech, the Guide can be downloaded here: https://www.orrick.com/en/Insights/2025/01/Orrick-Legal-Ninja-Series-OLNS-13-M-and-A-in-German-Tech.

Sec. 19a Instruments: The tax implications for employees holding sec. 19a instruments in the event of an exit have already been described above under A III.2.1.3. (sec. 19a shares) and A.III.2.4. (PPRs). In summary, wage tax becomes due on the dry income that arose when the sec. 19a instrument was granted, but the payment of which was deferred. Accordingly, it is essential during the exit process to ensure that the target company receives sufficient liquidity to pay the wage tax due on the initial dry income to the tax authorities. This is typically achieved by having the buyers pay a portion of the purchase price—equal to the wage tax amounts becoming due—directly to the target company, with debt discharging effect towards the selling shareholders. Moreover, sec. 19a shares are not treated differently from other real shares in the target company that are sold during the exit. The treatment of PPRs, by contrast, will depend on their specific structure and terms:

- If the PPRs are structured to mirror common shares in that they do not provide for a cash settlement in the event of an exit, employees holding PPRs participate in the exit proceeds by selling their PPRs to certain shareholders (not the target company itself) designated by the target company. Such an exit structure is typically supported by a call option granted by the respective employee. The buyer will acquire both the shares in the target company and the PPRs—similar to a shareholder loan—from the shareholders (or the PPRs will be settled in another manner as part of the exit; for example, by having the selling shareholders contribute the PPRs to the target company at closing).
- If the PPRs stipulate that, in the event of an exit, an amount equivalent to the exit proceeds of a similarly participating common shareholder is payable, the PPR will generally be settled by making a corresponding payment to the relevant beneficiary. In terms of exit structuring, such a PPR raises the same issues as the termination of a VSOP (*e.g.*, treatment as a debt item or debt assumption by the selling shareholders; see next section).

VSOP: Under a VSOP, beneficiaries have cash payment claims against the target company in an exit (regarding the payment amount, please refer to Chapter A.IV.5.). One option to deal with these claims is for the parties to treat them as a debt item and have the buyer deduct such debt item from the equity value that determines the purchase price the buyer has to pay for the shares in the target company. It would then be the buyer's responsibility to ensure that the target company has sufficient liquidity to settle such claims after closing, including any wage tax amounts and social surcharges becoming due at the time of the settlement.

There is some uncertainty whether treating VSOP obligations as liabilities of the target company might be seen as a hidden profit distribution (*verdeckte Gewinnausschüttung*), since these obligations arise from the sale of the target's shares, a seller-level transaction. The buyer wants to avoid such hidden distributions because they are not tax deductible, increase the target's taxable profit, and trigger German withholding tax, risking compliance issues. Practically, sellers often assume VSOP obligations with debt-discharging effect (*schuldbefreiende Übernahme*) before closing or indemnify the target company against them. This leads to the same economic outcome for sellers. In that case, the buyer pays part of the purchase price corresponding to the VSOP obligations directly to the target company, ensuring liquidity for VSOP payments and fulfillment of wage tax and social security withholding obligations.

WHEN IMPLEMENTING A VSOP – MAYBE ALREADY ADD SOME CLAUSES TO YOUR SHAREHOLDERS' AGREEMENT

As we have seen, care must be taken when structuring VSOPs to ensure that they do not constitute a hidden distribution of profits. It needs to be carefully reviewed whether the agreement of a VSOP between the company and the employee can still be considered "in the interest of the company" according to the criteria developed by case law, as otherwise there is a risk that the tax authority might consider the VSOP payments to be a hidden distribution. Although we do not share this view, some see such a risk in particular in case of an exit by sale of shares because in this case, the shareholders and not the company will profit directly from the exit transaction while the company bears the burden of the VSOP.

In order to counter the risk of a hidden distribution, a feasible way is therefore for the shareholders to agree with the company at the time the VSOP is established to indemnify the company against payment obligations arising from the VSOP out of proceeds from the exit. In the case of an exit by sale of shares to an investor, the investor would without such indemnification often take into account the obligations resulting from the VSOP by reducing the purchase price, so that the initial assumption of such liabilities by the shareholders should ultimately not negatively affect their economic position. Of course, it must be ensured that the shareholders only have to service their indemnification obligations from genuine cash inflows. At the level of the shareholders, a subsequent exemption payment will reduce their capital gain from the sale of shares. In other cases, in practice, the shareholders assume the company's VSOP payment obligations internally or *vis-à-vis* the employee shortly prior to a share sale transaction, *i.e.*, before the payment obligation becomes unconditional and due.

5. EMPLOYEE OWNERSHIP PLANS IN A DISTRESSED SITUATION

No one wants to do a financing round in a distressed situation at lower valuation points than prior rounds, particularly an insider-led down round, but they are a fact of start-up life. Frankly, such an insider-led round is not a standard Series A/B/C financing. It is a much more involved, complicated and potentially risky process that involves high stakes and often happens over a very compressed timeframe. Tension may run high between founders, management and investors (and even between investors who came in at different stages as they have a divergence of interests and differences in ability to continue funding their portfolio companies). Inside-led down rounds—particularly when viewed after the fact (that is, when) the start-up survives and gets back on its feet—can look unnecessarily punitive (remember: hindsight is 20/-20), even if the parties believed at the time that the terms were the "best available" and that there were no other viable alternatives.

In such down round scenarios, the investors willing to provide a lifeline will frequently request preemptive increases of the company's Employee Ownership pool or the set-up of a new Employee Ownership program altogether. Reasons will usually be twofold:

- Given reduced valuations, diminished exit prospects and potentially a return of the participating liquidation preference (in "structured financings" the latter is frequently requested by the investors willing to shoulder the financial burden of the recapitalization efforts), the company may need to issue additional Awards or in case of VSOPs Awards with lower base prices to the existing beneficiaries to keep talented employees incentivized.
- Participating new investors will also want to make sure that they will not get diluted by future pool increases, but instead that the preemptive increase is economically borne by the existing shareholders.
- Since investors generally will not want the (active) founders to be massively diluted (the Employee Ownership plan's increase would come on top of a round that, potentially amplified by the additional issuance of anti-dilution shares, is already highly dilutive for existing shareholders), it is not uncommon that a portion of the pool increase is reserved for a "re-up" of the founders (maybe in the form of growth shares). In most cases, therefore, a down round is primarily a "problem" for early investors not participating in the round as they bear nearly all the dilution.

In addition to the "reloading" of Awards out of the increased pool mentioned above, there are also other tools available in a distressed scenario to keep the core managers incentivized, including the following:

- **Repricing Existing Awards**, *i.e.*, resetting/reducing the base price or strike price of existing Awards (where applicable) to ensure that the management team's Awards are not "underwater" or out-of-the-money.
- **Management Carve-out Plans:** Given that German market Awards usually tie the proceeds under an Employee Ownership program to the amount received by a holder of a common share in an exit, "heavy" liquidation preferences can give management pause because their Awards are at the bottom of the liquidation waterfall (also referred to as the "liq pref stack"). One way to provide management an "up stack" incentive at the top of the waterfall is via a so-called *Management Carve-out Plan*. These plans sit below debt, but above equity (or at least somewhere between the more senior classes of preferred shares in the waterfall) and effectively "carve out" value that otherwise would go to shareholders and transfer that value to designated managers and key employees. This is done by providing participants in the plan a right to payments at, and contingent on, a sale of the company.
- **Exit Bonuses:** A straightforward and flexible way to focus key executives' attention on the exit and the underlying process is a one-time bonus linked to the success of the exit. These bonuses can be based on targets such as the sale price, timing of the deal or other metrics. This ensures that key employees are motivated to work towards a smooth and successful exit. The size of the bonus can correspond to their role and impact on the exit. The bonuses need to be substantial enough to make a meaningful difference to employees.
- **Retention Bonuses:** In some cases, key personnel who are at risk (or financially struggling) may be offered retention bonuses to keep them inside the fold.

Please note that any of these approaches will require proper legal advice and tax analysis before moving into execution territory.

VI. ESOP/VSOP and Accounting Matters

Finally, we would like to turn to a "technical" but nonetheless important topic: the accounting of Employee Ownership programs.

As we have shown above, employees often earn income in connection with ESOPs and VSOPs when shares are granted or Awards settled in cash (so-called income from employment). For the company, regular wages for employees generally represent personnel expenses. However, the accounting treatment of wages from VSOPs and ESOPs has not yet been clarified beyond doubt in all questions.

The International Financial Reporting Standard No. 2 ("IFRS 2") "Share-based Payment" prescribes in its detailed rules on the recognition of ESOPs/VSOPs as an expense:

- **Employees' Entitlements Settled Through Equity Instruments** must be measured at fair value from the grant date and recognized as personnel expenses in the income statement on a *pro rata* basis over the vesting period at each balance sheet date. The offsetting entry must be made in the capital reserve. After exercising the Award, the amount accruing to the company is divided into the subscribed capital and the capital reserve in accordance with IFRS 2.
- **Employees' Entitlements With Cash Settlement** (*e.g.*, VSOPs and potentially accordingly structured PPRs) are to be recognized as personnel expenses on the basis of the fair value on each balance sheet date and recognized as an offsetting item in a provision. In accordance with international regulations, personnel expenses are also allocated *pro rata temporis* over the vesting period. Personnel expenses are remeasured at each balance sheet date, depending on the development of value.

Unfortunately, comparable regulations are missing in German law. Rather, the accounting of ESOPs and VSOPs is neither explicitly regulated in the German Commercial Code (*Handelsgesetzbuch*) nor in the German Income Tax Act, which is of primary importance for tax accounting rules. Therefore, for accounting purposes, the principles developed in accounting literature and case law in connection with stock options issued by stock corporations as well as those established for the treatment of PPRs, may be used as precedents.

1. ESOP

In German commercial and tax law, the question of the correct accounting treatment has not yet been conclusively clarified. There is disagreement as to whether the granting of Awards and their economic development in the vesting period prior to exercise are not to be entered in the commercial balance sheet and in the tax balance sheet and thus remain neutral in terms of income or whether they are to be recognized in profit or loss. In addition, the corresponding valuation is also disputed. This is particularly true for PPRs issued for employee incentivization purposes under sec. 19a EStG, which—depending on their specific structure—may be classified as either equity or debt capital, and potentially even differently for commercial and tax accounting purposes.

In practice, different approaches are taken in the commercial and tax balance sheets:

Commercial Balance Sheet: It is now commercial practice to book personnel expenses for the Award, combined with an increase in the capital reserve: Awards represent a remuneration component of the employees over the vesting period, as they replace a corresponding cash remuneration. The work performance reflecting the value of the Award at the time of the commitment was also quasi contributed by the employees to the company over the vesting period in order to obtain the exercise of the option right and thus the possibility of a future shareholder position, just like a buyer of an Award. This is to be recorded as a contribution to the capital reserve. It is predominantly argued that personnel expenses should be booked *pro rata temporis* and that the capital reserve should be serviced *pro rata temporis*. The presentation of the transaction in financial statements according to IFRS 2 "Share Based Payment" also corresponds to this last variant.

Less frequently, it is argued in practice that the offsetting entry for the expense from the granting of the Award should initially not be recorded in the capital reserve, but through the formation of a liability provision. Only when the option is exercised shall the provision be converted into a capital reserve.

The recognition of the Award in form of real shares as an expense and in the capital reserve (prevailing opinion) or in a provision (minority opinion) requires a valuation of the Award in each case. According to the prevailing opinion, it is to be valued at its fair value at the time it is granted. Accordingly, there is generally alignment between the determination of the non-cash benefit, which is subject to wage tax, and the employer's liability. The value determined this way is recognized as an expense over the vesting period, *i.e.*, in instalments, and in the capital reserve. The expense reduces the annual company result (but not equity). If the Awards in form of real shares are not issued directly by the company but are instead received through a secondary acquisition from a shareholder, this transfer does not generally affect the commercial and tax balance sheet treatment at the employer level.

The commercial accounting treatment of PPRs is based on the criteria of IDW HFA 1/94. If a PPR is subordinated, providing a share in liquidation proceeds, loss-sharing and long-term, it can be recognized as equity (generally as outlined above for real shares); if one of these criteria is not met, it must be recognized as debt (so that the commercial accounting rules summarized below for VSOPs should generally be applicable to such kind of PPRs). Recognition as a special item is not permitted.

Tax Balance Sheet: For the tax balance sheet, the practice follows the principles of the case law of the BFH, according to which the granting of Awards in the form of options is irrelevant for accounting purposes until they are exercised. The issue of Awards within the framework of an option plan, which is linked (in case of a stock corporation) to a conditional capital increase, is rather neutral for the company in terms of profit or loss. The issue of the options would only have an effect on the existing shareholders as a so-called dilution of the value of the previously existing shares. Moreover, the company would only have to distribute the issue price to the subscribed capital and the capital reserve when exercising the Award and to record the corresponding additions.

Accordingly, only the exercise of the Award in form of an option by the employees or the initial receipt of real shares from the company leads to a recognition in the tax balance sheet. The issue price to be paid by the employees is to be added to the subscribed capital up to the amount of the nominal value of the issued shares. The excess amount is to be transferred to the capital reserves of the issuing company as a so-called "*agio*". There is still uncertainty as to when and to what extent tax expense will be recognized in such cases.

Pursuant to the tax authorities' view (which is disputed in several respects), the tax balance sheet treatment of PPRs is separate from the commercial balance sheet treatment: If a PPR holder is not also a shareholder, or if there is otherwise reason to assume a repayment obligation, the PPR capital must be recognized as debt in the tax balance sheet. Accordingly, the same principles generally apply to a PPR as to a VSOP liability (see below). However, PPRs are distinct in that they involve a capital contribution from the employee ("*skin in the game*"), as PPRs are essentially financing instruments. Unlike with VSOPs, it must therefore be determined whether—and to what extent—a liability must be recognized upon issuance of the PPR in the tax balance sheet. There are particular discussions as to whether this liability should be recognized only in the amount of the capital contribution, at the fair value of the PPR, or whether, in certain cases, no liability can or must be recognized at all. Since neither case law nor tax authority guidance provides clarity, and in the absence of a market standard, companies might consider seeking a binding ruling (*verbindliche Auskunft*) to avoid unforeseen negative tax consequences. The recognition (or non-recognition) of a liability in the tax balance sheet at issuance of the PPR can have significant tax implications in the future, such as realization of a taxable gain if the PPR is terminated or repurchased below the nominal value of the originally recognized liability.

It should be noted that if ESOPs are expensed in the commercial balance sheet but not in the tax balance sheet, the resulting difference in accounting creates deferred taxes that must also be recognized in the commercial balance sheet.

2. VSOP

VSOPs are fulfilled by the company at the time of the exit or other events to which a payment claim of the employee is linked (so-called "*trigger event*") by a cash payment amounting to the difference between the agreed base price and the value of a company's common share at that time. The employee's right to payment and the company's liability arise only when the last condition is met.

Tax Balance Sheet: In its decision of 15 March 2017 (I R 11/15), the BFH ruled that provisions for (contingent) liabilities from an Employee Ownership program in favor of executive employees cannot be formed as long as the condition has not (almost certainly) been legally created. These principles are transferable to VSOPs, which also convey conditional claims (on the occurrence of a trigger event). Only at the time when the trigger event (almost certainly) occurs does the company have to recognize the expense from the VSOP and report a payment obligation or the disposal of money.

Commercial Balance Sheet: According to the prevailing opinion in the literature, the employee's (conditional) claim for payment from the company prior to the occurrence of the trigger event is only to be recognized as a personnel expense if the occurrence of a trigger event (regularly an exit) has a certain probability. As an offsetting entry, a corresponding provision must be created from the balance sheet date at which this probability exists. However, there is disagreement about the degree of probability that must be achieved for the recognition of expenses and the formation of provisions. The spectrum of opinions ranges from "Exit must already be economically essentially agreed/foreseeable on the balance sheet date" to "Exit is not entirely improbable". We believe it is correct to require a higher degree of probability for the formation of provisions, which leads to a later initial formation of provisions. In practice, however, discussions with auditors and advisors at an earlier balance sheet date may arise.

Another important difference to the (genuine) share option is the valuation: Unlike with a share option, the maximum expense and provision are not already determined by the value of the VSOP entitlement at the time of its initial commitment, but have to be (re-) calculated on each balance sheet date on the basis of the current fair value of the conditional entitlement.

This means that the company's provision for a VSOP (corresponding to the impending payment obligation when the trigger event occurs) can rise very sharply and thus far above its initial value if the company's value increases sharply. When the cash compensation is paid out at the time of the trigger event, the provision is reversed.

If the commercial balance sheet approach differs from that under tax law, deferred taxes result from the different accounting under the German Commercial Code and tax law.

B. Our International Platform for Technology Companies

Chambers AND PARTNERS

The leading international law firm directory ranks Orrick in **Tier 1 for Venture Capital Germany** and lists our partner Sven Greulich as one of the Top 3 VC lawyers in Germany (2025)

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PitchBook

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PitchBook FY 2024

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Orrick counsels more than 4,000 venture-backed companies and 100+ unicorns as well as the most active funds, corporate venture investors and public tech companies worldwide. Our focus is on helping disruptive companies tap into innovative legal solutions. We are ranked Top 10 for M&A globally as well as for the U.S., for Europe and for Germany (LSEG, through the third quarter of 2025) and the #1 most active law firm in European venture capital (*PitchBook*).

The 2025 State of European Tech Report prepared by *Atomico* in partnership with AWS Amazon Web Services, Orrick, HSBC Innovation Banking, and Slush, is the deepest, data-led investigation into the European tech ecosystem and empowers us all to make data-driven decisions in the year to come.

A TRULY GLOBAL PLATFORM.

Coatue
as co-lead investor in N26's $900 million Series E

GIC
in its investment in Sunfire's €215 million Series E

TDK Ventures
in its investment in Ineratec's €118 million Series B

Proxima Fusion
in its €145 million Series A

Haniel
as co-lead investor in 1Komma5°'s €215 million Series B

Taktile
in its $54 million Series B

120+ Flip Transactions
advised more than 120+ German start-ups on getting into a U.S./German holding structure and subsequent financings

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10 of the world's **20 largest public tech companies**

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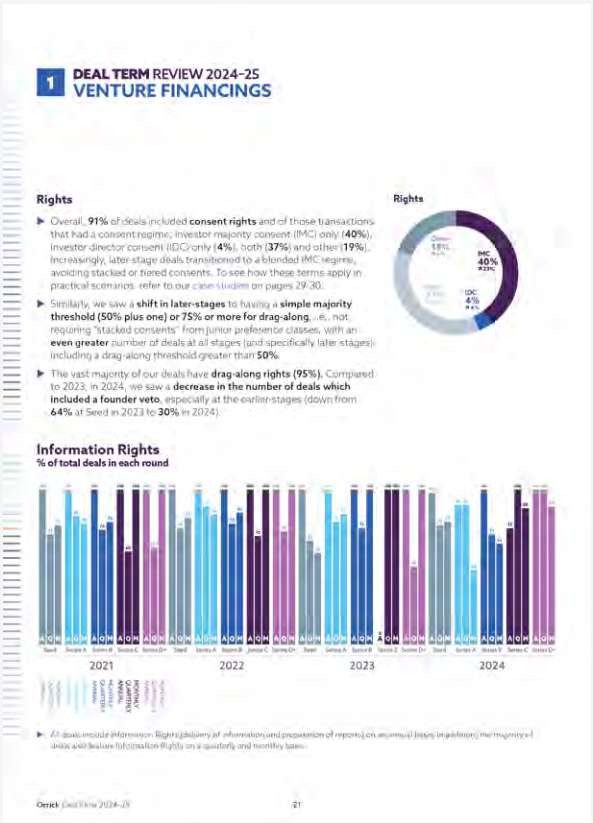
European Startup Health Check

Is your startup ready to take the next step on the entrepreneurial journey? Orrick's European Startup Health Check gauges your company's readiness for the next phase of growth.

Since AI is becoming a critical component for many startups, the Startup Health Check also covers artificial intelligence to ensure it is leveraged responsibly and effectively. The tool will help you assess AI usage, data management, licensing agreements, contract updates, and internal risk management frameworks.

Complete the Startup Health Check to receive a detailed report highlighting areas you may want to focus on and get connected with members of Orrick's Technology Companies Group who can help guide you through your company's next phase of development.

orrick.com/eu-healthcheck



Deal Flow 5.0

We analyze our closed venture financing transactions and convertible loan note financings across our European offices, to offer strategic insight into the European venture capital market:

Over 375 venture financing deals across Europe in 2024, raising more than $7.1 billion which make up over 25% of the total capital raised across the region.

Based on first-hand insights from the law firm that closed more than twice as many venture deals as any other firm in Europe in the last several years, we have unique insights for investors and high-growth companies into the customs in the European venture market.

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we know what has been contractually regulated in hundreds of venture transactions each year that Orrick advised on in Europe.

And we can break this data down by various categories such as geography, financing type, series, volume, type of investors involved and much more.

You will find our most recent edition of Deal Flow at orrick.com/dealflow.

GERMAN TECH RESOURCES

FOR FOUNDERS AND INVESTORS IN GERMANY

Forms

- Incorporation Questionnaire (Germany)
- VSOP Questionnaire (Germany)
- US-Flip Questionnaire (Germany)...

...and much more

Insights

- #FounderTeams in German Start-ups – Part I: Team...
- #DefenseTech – Regulatory Requirements for...
- #ESOP: How to Deal with the New Case Law on the...

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Featured

M&A Exit Quick Takes

FAQs

- Germany: What are the most common ways to structure seed financings?
- Germany: What is the legal form typically used in Germany for the incorporation...
- Germany: What are the different types of equity awards available in Germany?...

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D. Glossary

Acceleration	A provision that allows Awards (options or shares) to vest earlier than scheduled, typically upon a company sale or other defined event.
Allocation Letter	A document specifying the individual terms of a stock option or participation grant to an employee.
Anti-dilution Protection	A mechanism to protect option holders or shareholders from dilution in the event of future capital increases.
Awards	A term we use in this Guide for all forms of virtual or "real" shares, options for shares and PPRs issued under an Employee Ownership plan.
Bad Leaver	An employee who leaves the company under unfavorable conditions (*e.g.*, termination for cause), often forfeiting some or all vested Awards.
BAG	The German Federal Labor Court (*Bundesarbeitsgericht*).
Base Price	See Strike Price, these terms are usually used interchangeably.
BewG	The German Valuation Act (*Bewertungsgesetz*).
BFH	The German Federal Fiscal Court (*Bundesfinanzhof*).
BGB	The German Civil Code (*Bürgerliches Gesetzbuch*).
Cap Table (Capitalization Table)	A table showing the ownership stakes, equity dilution, and value of equity in each round of investment.
Clawback Provision	A contractual clause allowing the company to reclaim bonuses and payments under Awards if certain conditions are met (*e.g.*, breach of contract, competition).
Cliff	A minimum period an employee must remain with the company before any Awards begin to vest.
Convertible Loan	A loan that can be converted into equity, often used in early-stage start-up financing.
Dilution	The reduction in ownership percentage caused by the issuance of new shares, convertible loans or Awards.
Double Trigger	Vesting acceleration upon two events, usually the sale of the company (exit) and the employee remaining with the company for a certain period of time post-exit (or being fired by the company without good reason).
Drag-along Right	A contractual right that enables majority shareholders to force minority shareholders to join in the sale of a company.
Dry Income	Taxation of a benefit (*e.g.*, shares) before the employee has received any liquidity to pay the tax.
Employee Ownership	An umbrella term we use in this Guide for various forms of employee participation in the equity upside of their employer start-up, including ESOPs and VSOPs.
Equity Grant	The allocation of Awards to an employee.
ESOP	Is an abbreviation for employee stock option plan (sometimes also for equity stock option plan) and in the terminology of this Guide means a form of an Employee Ownership program that is equity-based and under which an employee receives real shares, options for real shares or PPRs.
EStG	The German Income Tax Act (*Einkommensteuergesetz*).
Exit Event	A liquidity event such as a sale of the company, IPO, or merger, allowing shareholders and option holders to realize value.

Fair Value	The price at which an asset would change hands between a willing buyer and seller, used for tax and option pricing (in Germany, the fair value determination needs to comply with the BewG).
Fully-diluted	A calculation of share ownership that considers all shares, and convertible securities, warrants and Awards (assuming them being exercised).
Good Leaver	An employee who leaves the company under favorable conditions (*e.g.*, retirement, disability, termination without cause), usually retaining vested Awards.
Growth Shares / Hurdle Shares	A special class of shares that entitle employees to participate only in the future increase in company value above a defined threshold (the "hurdle"), often used to optimize tax treatment and avoid dry income.
Hurdle Amount	The minimum company valuation that must be reached before holders of growth or hurdle shares participate in exit proceeds (calculated as a *pro rata* amount per hurdle or growth share).
Leaver Event	Any event (*e.g.*, resignation, termination, retirement) that triggers the application of leaver provisions in an Employee Ownership plan.
Leaver Provisions	Rules determining what happens to an employee's Awards if they leave the company.
Liquidation Preference	A right that determines the order and amount of payments to shareholders in the event of a company sale or liquidation.
ManCo (Management Company)	A pooling vehicle used to hold employee shares collectively, often as a limited partnership.
Negative Vesting	A provision where vested Awards are forfeited incrementally over time after an employee leaves, until a floor is reached (as the case may be) or an exit occurs. Sometimes, all vested Award will be forfeited at once only after expiration of a certain period of time following the leaver event unless an exit event has occurred by then.
Option Pool	A reserved portion of a company's equity set aside (directly or economically) for allocation of Awards to employees under ESOPs, VSOPs, or similar programs.
Performance-based Vesting	A vesting schedule that depends on the achievement of specific company or individual performance targets.
PPR	Profit participation rights (*Genussrechte*), *i.e.*, equity-like instruments entitling holders to participate in profits, liquidation proceeds, and/or exit proceeds, without shareholder rights.
Refresher Grant	An additional grant of Awards to employees after the initial grant, to maintain motivation and retention.
Single Trigger	Vesting acceleration upon a single event (*e.g.*, company sale)
Special Purpose Vehicle (SPV)	A legal entity created for a specific purpose, such as holding employee shares for tax or administrative reasons.
Strike Price	The price at which an employee can purchase shares under an option plan. In German plans, in particular VSOPs, the strike price is a mere deductible in the calculation of the employee's payment claims under the VSOP and does not actually have to be paid by the employee.
Top-up Grant	See Refresher Grant, these terms are usually used interchangeably.
Vesting	The process by which employees earn the right to keep their granted Awards over time, according to a fixed schedule or upon achievement of certain milestones in case of a performance-based vesting (see above).
VSOP	Is an abbreviation for virtual stock option plan and is form of an Employee Ownership program that simulates the economic benefits of an ESOP without issuing real shares, granting employees a contractual right to a cash payment upon an exit event.

Other Issues in this Series

orrick.com/olns

OLNS #1 – Venture Debt for Tech Companies

May 2019

Venture Debt is a potentially attractive complement to equity financings for business start-ups that already have strong investors on board.

This is a highly flexible instrument with very little dilutive effect for founders and existing investors.

OLNS #2 – Convertible Loans for Tech Companies

August 2019

Due to their flexibility and reduced complexity compared to fully-fledged equity financings, convertible loans are an important part of a start-up's financing tool box. In a nutshell: a convertible loan is generally not meant to be repaid, but to be converted into an equity participation in the start-up at a later stage.

OLNS #3 – Employment Law for Tech Companies

January 2023 - updated and expanded edition replacing the 2019 edition

Young technology companies are focused on developing their products and bringing VC investors on board. Every euro in the budget counts, personnel is often limited, and legal advice can be expensive. For these reasons, legal issues are not always top of mind. But trial and error with employment law can quickly become expensive for founders and young companies.

OLNS #4 – Corporate Venture Capital

March 2020

Corporates are under massive pressure to innovate to compete with new disruptive technologies and a successful CVC program offers more than capital – access to company resources and commercial opportunities are key features that justify CVC's prominence. This guide serves to share best practices for corporates and start-ups participating in the CVC ecosystem and also to ask important questions that will shape future direction.

OLNS #5 – Venture Financings in the Wake of the Black Swan

April 2020

In the current environment, all market participants, and especially entrepreneurs, need to be prepared for a softening in venture financing and make plans to weather the storm. In this guide, we share some of our observations on the most recent developments and give practical guidance for fundraising in (historically) uncertain times. We will first provide a brief overview of the current fundraising environment, and then highlight likely changes in deal terms and structural elements of financings that both entrepreneurs and (existing) investors will have to get their heads around.

OLNS #6 – Leading Tech Companies Through a Downturn

May 2020

Steering a young technology company through a downturn market is a challenging task but if done effectively, the start-up can be well positioned to benefit once the markets come back. While OLNS#5 focused on raising venture financing during a downturn, in this guide, we want to give a comprehensive overview of the legal aspects of some of the most relevant operational matters that founders may now need to deal with, including monitoring obligations and corresponding liabilities of both managing directors and the advisory board, workforce cost reduction measures, IP/IT and data privacy challenges in a remote working environment, effective contract management and loan restructuring.

OLNS #7 – Flip it Right: Two-Tier U.S. Holding Structures for German Start-ups

July 2024 - updated and expanded edition replacing the 2021 edition

Operating a German technology company in a two-tier structure with a U.S. holding company can have great advantages, most notably with respect to fundraising in early rounds and increased exit options and valuations. However, getting into a two-tier structure (be it through a "flip" or a set-up from scratch) requires careful planning and execution. This guide shows you what to consider and how to navigate legal and tax pitfalls.

OLNS #9 – Venture Capital Deals in Germany: Pitfalls, Key Terms and Success Factors Founders Need to Know

October 2021

Founding and scaling a tech company is a daunting challenge. OLNS#9 summarizes our learnings from working with countless start-ups and scale-ups around the world. We will give hands-on practical advice on how to set up a company, how (not) to compose your cap table, founder team dynamics and equity splits, available financing options, funding process, most important deal terms and much more.

OLNS #10 – University Entrepreneurship & Spin-offs in Germany: Set-up / IP / Financing and Much More

November 2022

German universities are increasingly becoming entrepreneurial hotbeds, but university spin-offs face some unique challenges. OLNS#10 helps founders by providing them with an overview of how to get a university-based start-up off the ground. We will discuss founder team composition and equity-splits, the cap table composition, important considerations for the initial legal set-up (founder HoldCos and U.S. holding structures) as well as financing considerations. We will also return again and again to the specifics of IP-based spin-offs, especially when it comes to how a start-up can access the university's IP in an efficient manner.

OLNS#11 – Bridging the Pond: U.S. Venture Capital Deals from a German Market Perspective

August 2023

Venture financings and deal terms in the U.S. and in Germany have many similarities but there are also some differences. To help navigate these challenges, we have put together OLNS#11. The guide offers founders and investors with a "German market" background an introduction to U.S. VC deals and helps them understand where U.S. deals differ from a typical German financing. OLNS#11 also augments and builds on OLNS#7 that explains how German founder teams can get into a U.S./German holding structure.

OLNS#12 – Advisory Boards in German Start-ups: Role / Duties and Liability / Best Practices

November 2024

Advisory boards are a standard corporate governance feature and its start-up specific tasks develop over time when the company matures. OLNS#12 summarizes the role of the advisory board, duties and liability risks, practical guidance regarding its appropriate size and composition and gives best practices for a functioning advisory board. Throughout the guide, experienced investors and founders share their lessons learned when it comes to board competencies and how best to deliver value. In addition, this guide presents the first results of the OLNS Board Study 2024/2025, an empirical study on the size and composition of advisory boards in the various financing stages of more than 2,900 German start-ups.

OLNS#13 – M&A in German Tech: A Playbook for Buyers and Sellers

January 2025

The German tech ecosystem matures and achieving exits is arguably one of the last missing ingredients to supercharge the German tech ecosystem. In a stubbornly difficult IPO market, mergers and acquisitions often offer the only practical route to liquidity for high-growth companies and its investors.

With special attention on the sale of venture-backed tech companies, this playbook provides buyers and sellers a guide to approaching M&A transactions involving German tech companies.

OLNS#14 – Growth and Hurdle Shares in German Start-ups: Structures / Practical Implementation / Empirical Data

March 2025

In German start-ups, Growth Shares are particularly intriguing for motivating key employees and late co-founders. This is especially true when the company has already reached a substantive equity value, making further stakes in the company hardly affordable or burdened with hefty taxes. While for "standard" shares, sec.19a German Income Tax Act now allows to defer the wage tax on the non-cash benefit, a better tax treatment can often be achieved with Growth Shares.

OLNS#14 explains the concept behind Growth Shares in detail and presents potential applications, provides practical assistance on implementation, highlights legal and tax pitfalls and presents the empirical results of an analysis of nearly 70 Growth Share programs that were implemented in German start-ups.

OLNS#15 – Founder Teams in German Start-ups – Team Size and Composition / Equity Splits / Empirical Data

July 2025

The composition of a founder team and the way equity is split can have far-reaching implications for the success of a start-up. In this guide, we will share general considerations and best practices and have experienced investors share their insights on what makes a strong founder team that has a shot at building a great company. In addition, OLNS#15 shares the results of the OLNS Founder Equity Study 2025, a unique empirical study of more than 2,100 German start-ups.

In addition to the in-depth publications of the Orrick Legal Ninja Series, in our **Orrick Legal Ninja Snapshots**, we pick up on the latest developments and provide you with quick, digestible insights into current legal issues that are highly relevant to the German venture/tech ecosystem.

Click here to find out more and follow our *Orrick Germany LinkedIn* page to keep up to date with future issues.

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