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GROWTH AND HURDLE SHARES IN GERMAN START-UPS

STRUCTURES / PRACTICAL IMPLEMENTATION / EMPIRICAL DATA

ANALYSIS OF
60+
GROWTH SHARE PROGRAMS
of German Start-ups

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VC & TECH BRIEFINGS GERMANY

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About the Orrick Legal Ninja Series – OLNS

In nearly every major market around the globe, our team of dedicated technology lawyers is on a mission to support the growth of young German tech companies at every stage of their journey. As one of the world's leading tech law firms, we're passionate about bridging the gap between the American and German entrepreneurship ecosystems.

That's why we kicked off the Orrick Legal Ninja Series ("OLNS") in 2019. This series offers insights into current legal trends and delves into topics that are particularly relevant for German start-ups and their investors.

Each OLNS edition is crafted by a cross-functional team of lawyers from our national and international offices. Our aim is to tap into our vast reservoir of venture capital, corporate venture capital, and technology expertise and share it with the vibrant German entrepreneurship and innovation community.

Why "Ninja Series?" This title might simply reflect the fact that some of us watched a little too much TV in the 1990s. But in all seriousness, "Ninja" has come to mean "a person who excels in a particular skill or activity". That's exactly what the Orrick team strives for—providing top-notch, tailored advice to growing tech companies and their investors. We hope OLNS also helps you become a Ninja entrepreneur.

If you'd like to chat more about this, please reach out. We'd love to hear your thoughts on the topics covered in this publication, so feel free to share your experiences with us. We're always looking to learn and grow to better serve our clients.

We hope you enjoy this fourteenth edition of OLNS.

On behalf of the Orrick Team,

Sven Greulich
Orrick – Technology Companies Group Germany

A. Growth and Hurdle Shares in German Start-ups

I. Introduction

In OLNS#8 "ESOP, VSOP & Co"[1], we explained the importance of employee participation programs for the incentivization of key employees as a critical success factor for start-ups. In the current edition of OLNS, we want to dive deep on a particular form of participation schemes, the so-called "Growth Shares,"[2] simultaneously also referred to as "Hurdle Shares" and occasionally as "Zero Shares", "NLP Shares" (NLP stands for "negative liquidation preference), "MIP Shares" (MIP stands for "management incentive program"), "Value Shares" or – albeit quite colorful, the authors have seen that label only on very few occasions – "Flowering Shares".

Growth Shares are particularly intriguing in private equity deals for motivating managers, and in start-ups, they're like a golden carrot for key employees or new members of the founding team (the so-called "late co-founders"). This is especially true when the company has already reached a high equity value, making further stakes in the company as hardly affordable or burdened with hefty taxes. For reasons that our friends from the tax team assure us are absolutely fascinating, German start-ups can, in most cases, issue real shares to their key executives or late co-founders only at fair value. If they don't, the spread between the fair value of the shares at the time of issuance and the acquisition price paid by the beneficiary is subject to wage tax (cf. sec. 19 para 1, sentence 1, no. 1 and sec. 8 para. 1 sentence 1 German Income Tax Act (*Einkommensteuergesetz* – "**EStG**") as well as sec. 2 of the Wage Tax Implementation Regulation (*Lohnsteuer-Durchführungsverordnung*)). Tax law colleagues refer to this spread as "non-cash benefit", and we will likewise speak of a or the **non-cash benefit** when referring to the amount of the benefit for managers, key employees, or late co-founders upon the issuance of shares. The wage tax on the non-cash benefit can be deferred until the future divestment of the respective shares under the conditions of sec. 19a EStG, as we will see. However, a better tax treatment can often be achieved with Growth Shares.

1. You can find all editions of the OLNS here: https://www.orrick.com/en/Practices/Orrick-Legal-Ninja-Series-OLNS.
2. Since we lawyers believe that being nitpicky should be an Olympic sport, we can't resist mentioning that in England (where Growth Shares have a longer history), the advisory practice sometimes distinguishes terminology based on whether the Hurdle is set according to the current company value at the time of share issuance (in which case they're called Growth Shares) or even higher (in which case they're referred to as Hurdle Shares). In England, while the distinction between "Flowering Shares" (these are usually defined as a special share class designed to allow the holders to participate in the value of the company only, or to a greater degree, if and when a specified performance condition is met) and "Growth Shares" is blurred in practice, it can still be important as the English tax authorities consider that "Flowering Shares" as convertible securities and will tax them accordingly. Alright, we will stop being nitpicky...

Technically speaking, Growth Shares are genuine company shares, but with a twist—they come with a negative liquidation and proceeds preference[3]. Imagine them as shares with a bit of a hurdle to jump over. They only join the party when a specific value, known as the "hurdle", is surpassed. This hurdle often matches the company's value at the time the Growth Shares are issued (but can also deviate from such value). So, these shares only get to enjoy the spoils of proceeds, distributions or liquidation gains once the hurdle is cleared.

For example, if the start-up were determined to have a current value of EUR 50 million, and the respective beneficiary receives 5% of the total outstanding shares of the start-up issued in the form of Growth Shares with the hurdle being set at the assumed current value of the start-up, then upon a sale of the start-up for EUR 110 million, the beneficiary would receive a (gross) payment in an amount of 0.05 x EUR 60 million (EUR 110 million–EUR 50 million) = EUR 3 million (leaving (positive) liquidation preferences of the holders of preferred stock, transaction costs, *etc.*, aside).

The negative liquidation preference reduces the fair value of Growth Shares at the time of their issuance, making them affordable for managers and founders. Once the hurdle is cleared and the shares start raking in sales or liquidation proceeds, these should ideally be taxed as capital income, not as income. This makes them a more tax-friendly option compared to purely virtual participation models and, as we'll see, even compared to real shares issued under the tax deferral model of sec. 19a EStG.

In Germany, participation programs that grant beneficiaries "virtual" share options or virtual shares are much more common than programs that issue "real" shares or options for "real" shares. Against the background of the tax and corporate law weaknesses of many equity-based programs, which we will discuss later, virtual share option programs ("**VSOP**") simply attempt to economically simulate the equity-based programs. In simple terms, the beneficiary receives a payment from the company in case of an exit event and the amount of such payment is based on, among other things, how much the holder of a common share in the start-up receives in the respective exit event. Hence, although knowledgeable consultants often need more than 20 pages for such programs, when viewed in the light of day, VSOPs are merely rather complex exit bonuses for employees. The few available surveys (and they date from a time when sec. 19a EStG shares were not yet available) indicate that more than 70% of the tech start-ups that have implemented some form of employee ownership programs in Germany rely on a VSOP. With the increasing market penetration of equity-based schemes under sec. 19a EStG, in particular in the form of profit participation rights, this situation is going to change in the years to come. The reason is straightforward: While a VSOP is easy to implement and administer, it is mildly tax-inefficient, minus the mildly. Payments under a VSOP are subject to the high wage taxation (ouch). Sec. 19a EStG instruments (in the form of real shares or profit participation rights) are more beneficial from a tax perspective. From a tax perspective, Growth Shares may even be more efficient, particularly when held through personal holding entities—an option that is not available for sec. 19a EStG instruments—Growth Shares still offer the potentially most attractive tax structuring. No worries, we will explain all of this in more detail in a minute.

While the concept of Growth Shares might seem as straightforward as a walk in the park, their implementation and administration can be quite the marathon (okay, not that complex, maybe a slow-paced half-marathon). There are also a few lingering uncertainties, especially when it comes to determining the "right" fair value (acquisition price) for the Growth Shares at issuance. Ultimately, the tax treatment of proceeds from Growth Shares as capital income is still awaiting the final word from the highest German tax court and their treatment by the tax authorities in the various German federal states is not always fully consistent.

In addition, one needs to keep in mind that Growth Shares are real shares that come with certain unalienable rights, *etc.* (unlike profit participation rights that can largely be structured without such rights). As we will see, when Growth Shares are issued to a larger group of beneficiaries, in order to keep the corporate governance manageable, simplify decision-making processes and streamline future financing rounds, the beneficiaries are often pooled through a pooling agreement and the interposition of a pooling entity (this is the "ManCo" we describe below) (one could also consider a trust structure as an alternative).

3. To be precise the negative liquidation preference applies not only to liquidation proceeds but to any exit proceeds or profit distributions.

This Guide explains the concept behind Growth Shares in detail and presents potential applications. It also provides practical assistance on some key aspects of implementing Growth Share programs and highlights how to avoid legal and tax pitfalls, while also pointing out where uncertainties remain. Finally, we present the empirical results of an analysis of nearly 70 Growth Share programs that were implemented in German start-ups, answering questions such as in which phase of the company start-ups launch such programs, to whom Growth Shares are issued, and how extensive these programs are in relation to the entire cap table.

To simplify things a bit, we will use the following terminology:

- **"Beneficiary"** refers to the acquirer of Growth Shares. These can be key executives of the start-up or *de facto* founders who join after the start-up's early days (late co-founders). Growth Shares can also be allocated to members of the initial founder team, for example, if one seeks to correct a too-large founder dilutions in the initial stages of the start-up. Although we refer to the Beneficiary as the holder of the Growth Shares for readability, it should be noted that for tax reasons, Beneficiaries often do not hold the Growth Shares themselves but through personal holding companies they control (usually in the form of a UG (*haftungsbeschränkt*), a legal entity under German law that can be thought of as a "GmbH light"). Sometimes, to simplify the corporate governance of the start-up, the Growth Shares are also held via a ManCo (as defined below). Beneficiaries are then involved as limited partners of the ManCo (indirectly through their personal holding companies). We will return to these variations and explain them in more detail later in this Guide.
- **"Growth Shares"** Although there are many largely synonymous terms in the market, such as Hurdle Shares, NLP Shares, Zero Shares, MIP Shares and Value Shares, we will consistently use the term Growth Shares. This refers to a class of real shares burdened with a negative liquidation preference in the amount of the Hurdle described below.
- **"Hurdle"** refers to the amount of the negative liquidation preference, where depending on the context, the term may refer to either the total amount of negative liquidation preferences or the amount per Growth Share. Simplified example: A start-up has so far issued common and preferred shares and 50,000 shares in total. The shareholders now want to issue Growth Shares. These Growth Shares shall not participate in the company's value which is currently assumed by the shareholders to be EUR 50 million, but only in the value created above this threshold. Therefore, the Growth Shares must be burdened with a negative liquidation preference of EUR 1,000 (EUR 50 million / 50,000 shares). EUR 1,000 is thus the hurdle per Growth Share, while the total hurdle amount is EUR 50 million.
- **"ManCo"** refers to a partnership, usually organized as a GmbH & Co. KG under German law, in which the Growth Shares (or sec. 19a EStG shares) of the Beneficiaries are pooled. Usually, the ManCo is qualified non-commercial for tax reasons through the involvement of a managing limited partner.

As always, unless the context clearly requires otherwise, references to one gender shall include all genders.

"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. What are Growth Shares?

A stake in a start-up with a theoretically unlimited equity upside can provide strong incentives for Beneficiaries and promote that important ownership culture. Offering equity can be a powerful tool to attract and retain talent, especially in start-ups where cash compensation might be limited or as Mark Twain put it: "The lack of money is the root of all evil." (for the unacquainted reader: in every edition of the OLNS, there is a quote from our beloved favorite author as we stubbornly believe it makes us sound smarter than we actually are).

1. ISSUES WITH GIVING REAL SHARES, IN PARTICULAR THE DRY INCOME TAXATION

As a quick reminder, the main issues with granting real shares to Beneficiaries of a German start-up organized as a GmbH or UG (*haftungsbeschränkt*) and some of the potential mitigation tools are the following:

ISSUES WITH REAL SHARES

Aspect	(Potential) Issues	Mitigation Approaches
Form Requirements	Issuance of 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 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).

Let's dive deeper on the dry income issue while in the next two Chapters 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 (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 and the shares' fair value upon grant (sec. 19 para. 1 sentence 1 no. 1 together with sec. 8 para. 1 EStG as well as sec. 2 of the Wage Tax Implementation Regulation). The Beneficiary would be taxed at a time when he gets 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.

Does an Initial Dry Income Taxation "Infect" Later Proceeds? Luckily, the answer is routinely "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.

2. 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 Growth 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 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 following Chapters, we first introduce the Growth Shares and the sec. 19a EStG shares in more detail, focusing on the Growth Shares. It is also conceivable to structure sec. 19a EStG shares as Growth Shares (this variant will be reserved for one of the upcoming OLNS editions, in which will delve deeper into sec. 19a EStG shares).

Finally, we illustrate with an example when each form of share is more advantageous for the Beneficiary in the event of an exit.

2.1 Growth Shares – Reducing the Fair Value

2.1.1 How Are Growth Shares Structured?

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.

In its judgment of November 16, 2022 (X R 17/20), the BFH paved the way that liquidation preferences should be considered in the valuation of shares under certain conditions. While the decision concerned positive liquidation preferences, the advisory practice infers from the judgment that negative liquidation preferences are also suitable for reducing the fair value of Growth Shares. 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 that we present later in this Guide, we found that in approx. 15% of the cases, the start-up issued Growth Shares as nonvoting shares). The background, simply put, is that the tax recognition of genuine employee participation programs is based on the Beneficiary being recognized both legally and economically (except for the negative liquidation preference) as the owner of a common share, meaning that for tax purposes, the Beneficiary also acquires what is known as beneficial ownership of the shares (see sec. 39 para. 1 of the German Fiscal Code ("**AO**") or sec. 39 para. 2 no. 2 AO when acquired through a ManCo). This is all the more questionable the more the contractual provisions for the Growth Shares deviate from the statutory model of a share in a company.

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. Under German tax law, this question is to be answered on the basis of the Valuation Act (*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. We will come back to this important question (see Chapter A.III.2.2.).

Those of our readers who had the good fortune not to study law but how to make real money will have noticed that Growth Shares are economically similar to a (real) share option with a market value exercise price or a virtual share option with a base price equal to a common share's then-current value. There are a few differences though:

- Taxes... Proceeds on virtual share options are subject to wage tax. In order to exercise a real share option, the holder has to pay the fair value of the shares at the exercise date of the option (or wage tax will become due on the spread between the exercise price and the fair value of the shares)[4].
- A real or virtual share option is risk-free: the holder makes no financial commitment until the option is exercised (in case of a real share option and which the holder will only do if the option is "in the money") or the exercise price is a mere deductible (in case of a virtual share option, where the virtual share plan will always floor any payments at 0). In contrast, the Beneficiary makes a—usually small (see below)—upfront investment in a Growth Share and will make a loss if it falls in value.

4. Is this the right moment to bring our favorite tax (lawyer) joke? "People who complain about tax (lawyers) can be divided into two groups: men and women."

2.1.2 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 (*Solidaritätszuschlag*) plus church tax (*Kirchensteuer*) 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. (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 EStG shares which can only be held directly. This is because capital income from sec. 19a EStG shares (that is the income from the increase in value above the fair value of the sec. 19a EStG shares upon issuance) is treated the same way as Growth Shares that the Beneficiary holds directly. In addition, the deferred wage tax on the non-cash benefit received upon the acquisition of the sec. 19a EStG shares (*i.e.*, the difference between the purchase price and the then fair value) must be paid at the time of the exit.

2.1.3 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, special rules have to be included in the shareholders' agreement and the start-up's articles of association. The valuation of these special shares is also regularly more complex and time-consuming (with respect to the question if and when an external appraisal of Growth Shares is advisable, see Chapter A.III.2.2.). Finally, special share classes are more susceptible to audits, and additional costs can also arise in external audits. In addition, unless Growth Shares are pooled in a ManCo (for details please see Chapter A.III.4.2.), the Beneficiaries will end up as shareholders on the cap table so that Growth Share concepts do not really scale beyond a few Beneficiaries. With respect to the potential problems that come with the issuance of real shares, please also refer to Chapter A.II.1.

2.2 Sec. 19a EStG Shares – Accept and Defer

In order to counteract the dry income issue described above, the legislator introduced in the summer of 2021 a fundamentally revised sec. 19a EStG (which has been already amended twice since then), by which the dry income taxation is not avoided but at least deferred.

This means that the wage on the non-cash benefit from the acquisition of the shares only becomes due when the Beneficiary transfers them or the company is dissolved (or the employment relationship is terminated, or latest after the expiry of fifteen years). The idea is that the 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 cash benefit (the difference between the value of the sec. 19a EStG shares at the time of acquisition and the purchase price paid). The increase in value since the acquisition is subject to the more favorable capital income taxation. However, the social security contributions on the non-cash benefit of the sec. 19a EStG shares must be paid by the start-up once the shares are acquired by the Beneficiary.

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 questioned. 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.

In one of the next issues of OLNS, we will take a closer look at the advantages and disadvantages of sec. 19a EStG instruments and their practical implementation, but at this point will limit ourselves to the below description and overview of the main differences between Growth Shares and sec. 19a EStG instruments.

Companies who want to use sec. 19a EStG instruments (these can be real shares or—as a most recent development—profit participation rights) need to fulfill the following criteria (this also applies for a transfer of existing shares from one of the start-up's shareholders if the transferee wants to benefit from the tax deferral pursuant to sec. 19a EStG):

- Upon issuance of the sec. 19a EStG instruments, the company must not be older than twenty years (previously twelve years).
- Upon issuance of the sec. 19a EStG instruments, the start-up must be a small or medium-sized enterprise ("**SME**"), *i.e.*,
    - <1,000 employees (previously 250) and ≤ EUR 100 million annual turnover (previously EUR 50 million); or
    - <1,000 employees (previously 250) and ≤ EUR 86 million balance sum (previously EUR 43 million).

These thresholds must have been met once in the current or the preceding six years (previously in the current or last year).

- The sec. 19a EStG instruments must be granted in addition to the remuneration owed to the employee.
- The acquiror of the sec. 19a EStG instruments must be an employee of the company that issues the sec. 19a EStG instruments or of its subsidiary.

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 restriction.
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.
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.

	Growth Shares	Sec. 19a EStG Instruments	VSOP
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 Beneficiaries current or past shareholding, plus church tax if applicable) as sec. 19a EStG instruments cannot be held 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.

2.3 Sample Calculation of the Different Tax Consequences

The following overview illustrates by a slightly simplified example the different tax consequences of Growth Shares and sec. 19a EStG instruments in several scenarios.

Example:

- A start-up is founded by two founders in the legal form of a GmbH. The founders each hold 12,500 common shares (shares without liquidation preference). As part of a financing round, investors invest EUR 10,000,000.00 in the start-up and in return receive 12,500 preferred shares (shares with a 1x non-participating liquidation preference) (post-money valuation: EUR 30,000,000.00). For simplicity reasons we assume that there are no further employment participation programs.
- Shortly after the financing round, a new CEO is hired. The CEO receives the following as an incentive: We will take a look at two different incentive packages:

  A. 500 Growth Shares in exchange for payment of the fair market value of the Growth Shares and the CEO will hold the Growth Shares via a personal holding entity, or

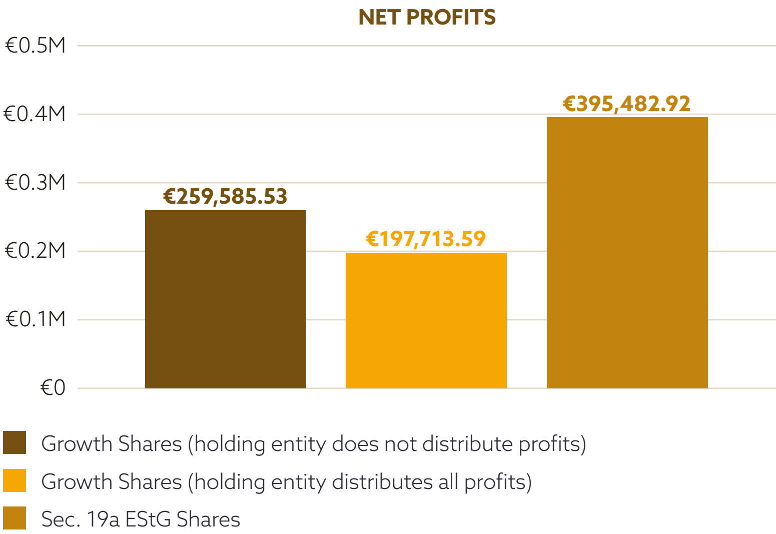
  B. 500 sec. 19a EStG shares, which he receives gratuitously and which he holds personally (remember, sec. 19a EStG instruments cannot be held via a personal holding entity).
- After some time, there is an exit in which all shares (preferred shares, common shares and Growth Shares) are sold to a buyer.

The following graphics show the comparison of the net proceeds of

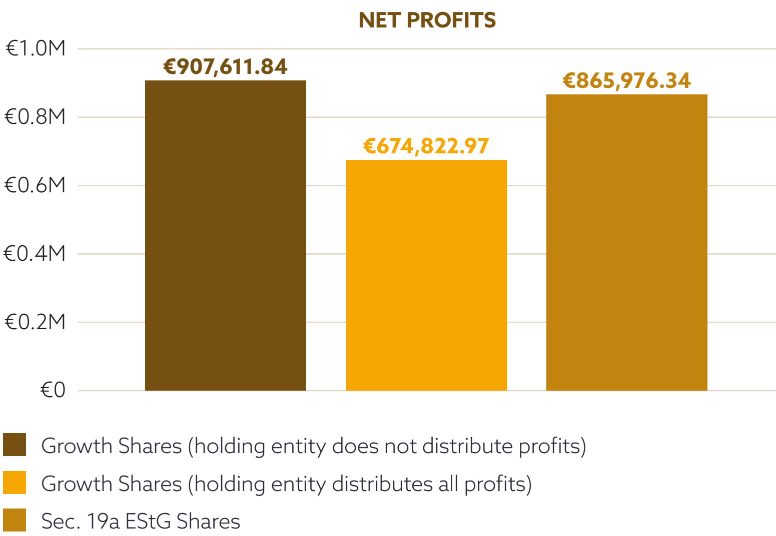
- Sec. 19a EStG shares at the CEO level,
- Growth Shares at the level of the personal holding entity (no distribution) and
- Growth Shares at the CEO level (full distribution),

in the case of total exit proceeds of EUR 50,000,000, EUR 100,000,000 and EUR 500,000,000 (think positive...):

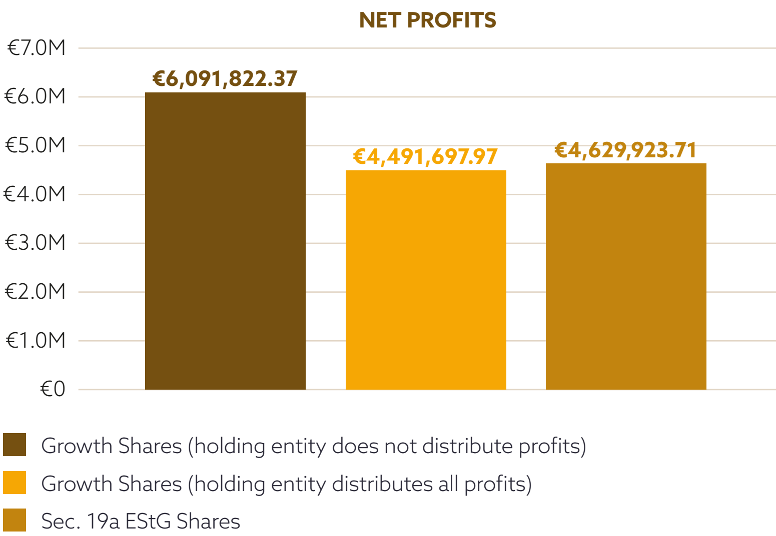
Total Exit Proceeds EUR 50,000,000



Total Exit Proceeds EUR 100,000,000



Total Exit Proceeds EUR 500,000,000



Assumptions:

- Negative liquidation preference of the Growth Shares: EUR 30,000,000.00 (amount of the post-money valuation);
- fair market value of the Growth Shares at the time of their issuance: EUR 50.00 per Growth Share.
- fair market value per sec. 19a EStG share at the time of their issuance: EUR 790.00;
- the CEO is not a member of a church;
- income tax / wage tax rate (incl. solidarity surcharge, excl. church tax): 47.475%;
- income tax on capital income applying the partial income method (incl. solidarity surcharge, excl. church tax) (cases of 1% or more equity share within last 5 years): 28.485%;
- tax on capital income (incl. solidarity surcharge, excl. church tax): 26.375%; and
- effective tax rate on capital gains for the holding entity: c. 1.5%.

The results show that Growth Shares are more tax-efficient when exit proceeds significantly exceed the Hurdle and if the proceeds initially remain in the personal holding entity (where they are available for further investments).

III. The Practical Implementation of Growth Shares

1. WHERE DO GROWTH SHARES COME FROM?

Growth Shares can generally originate from two sources:

Issuance of New Shares: The start-up can issue new shares as Growth Shares through a cash capital increase. If the start-up does not have authorized capital available for this purpose, a shareholders' meeting is required to approve the capital increase. In this case, the Growth Shares are issued directly as such, and the corresponding provisions are reflected in the company's articles of association and the shareholders' agreement. The Beneficiary pays the nominal value of the Growth Shares to the start-up. If the acquisition price is above the nominal value of the Growth Shares (see below), the difference must be paid as an additional contribution to the capital reserves of the company according to sec. 272 para. 2 Commercial Code (*Handelsgesetzbuch*).

Transfer of Existing Shares: The Beneficiary can also receive Growth Shares from existing shares. This can involve a share sale by the company itself, if it holds treasury shares (*e.g.*, from exercising a call option in case one of the initial founders has become a leaver), or by one of the existing shareholders. The sold shares must then be reclassified as Growth Shares through a corresponding amendment to the articles of association and the shareholders' agreement. In these cases, the sale price should correspond to the acquisition price described further below (the fair value of the Growth Shares).

2. DETERMINING THE HURDLE AND THE ACQUISITION PRICE

Let's address two questions of significant practical relevance:

- At what level should the Hurdle be set?
- What should the acquisition price for the Growth Shares be to avoid dry income taxation? The acquisition price when acquiring newly issued Growth Shares corresponds to the sum of the nominal amount per Growth Share (regularly EUR 1 in practice) and any additional contribution to the company's capital reserves, and when acquiring existing shares from the company or another shareholder, it corresponds to the relevant purchase price per Growth Share.

2.1 Determining the Hurdle

Hurdle Usually Set at the Current Equity Value: In practice, the Hurdle is usually set at the fair value of a common share at the time of the issuance of the Growth Share. If Growth Shares are issued in connection with or relatively shortly after a financing round, the Hurdle is then often set at the company's *pro rata* valuation in such financing round. Setting the Hurdle at the company's *pro rata* valuation during a financing round aligns the interests of new investors and Growth Shareholders by ensuring that Growth Shares only participate in value creation beyond the current valuation. However, the Hurdle can be higher which in turn might have consequences on the fair value of the Growth Share which the Beneficiary will have to come up with in order to avoid a dry income tax liability.

Dynamic Hurdle? To address uncertainties in setting the Hurdle and to account for the fact that a Hurdle to be considered in the future distribution of exit proceeds has a lower present value at the time when the Growth Shares are issued, it is – particularly with regard to start-ups that already regularly generate profits – sometimes suggested to have a dynamic Hurdle and apply an "interest" to the Hurdle. This means that the Hurdle increases by a certain percentage each year, with an "interest rate" of (at least) 5.5% being what is usually suggested. For clarification, "interest" does not mean that the beneficiary has to make (additional) annual payments to the company, but rather that the (remaining) Hurdle increases by the corresponding percentage each year. Whether and how a dynamic Hurdle may affect the fair value of Growth Shares will be clarified in the future, once the tax authorities and / or the fiscal courts express their views on the valuation-related implications of a dynamic hurdle for the first time.

In our analysis of German start-ups' articles of association, we identified more than 60 Growth Share programs. While in more than 25 cases the articles of association provided a specific Hurdle amount, only in one case did the articles of association include an interest on the hurdle, in that specific case at a rate of 5.5% p.a. (for details see Chapter A.IV.2.5.).

Scope of the Hurdle: As previously mentioned, the Hurdle applicable to each Growth Share is the negative liquidation preference burdening that Growth Share. From a tax perspective, the disadvantage in distribution inherent in the negative liquidation preference should apply both to the distribution of proceeds from the sale of shares and the distribution of any liquidation proceeds, as well as to distributions from the start-up to the Beneficiary (any deductions from the distributions are credited against the negative liquidation preference of the Growth Shares in the distribution of sale or liquidation proceeds).

PARTICIPATION OF THE BENEFICIARY IN THE EXISTING COMPANY VALUE ?

In some cases, the parties want the Beneficiary to participate not only through the acquisition of Growth Shares in the incremental future value but also in the current company value expressed in the Hurdle. This might be the case, for example, when it has been agreed with an external C-suite candidate that they should receive "5% of the start-up". As shown in this publication, a tax-attractive participation can be structured by issuing Growth Shares amounting to (fully diluted) 5% of the start-up to a holding entity held by the Beneficiary (assuming the Beneficiary is subject to German tax) and possibly assisting the Beneficiary with financing the fair value of the Growth Shares exceeding the nominal price (if applicable) through a loan. However, even in this case, the Beneficiary does not participate in the Hurdle, and thus usually not in the currently assumed company value. In practice, the Beneficiary sometimes receives (virtual) share options to the same extent, but the payout amount is limited to the Hurdle amount. Of course, these "top-up options" are then subject to higher income tax upon exit. It is also conceivable that, in addition to Growth Shares, the Beneficiary is granted sec. 19a EStG instruments instead of (virtual) share options, which provide them with a participation in the current company value up to the level of the Hurdle. In such a case, the Beneficiary would benefit from the deferred taxation of the non-cash benefit from the discounted provision of the sec. 19a EStG instrument and the favorable taxation of capital gains as capital income. However, it is currently not yet conclusively determined whether a correspondingly capped equity instrument can take advantage of the benefits of sec. 19a EStG.

2.2 Determining the "Right" Acquisition Price

In practice, there is some uncertainty around the "right" acquisition price.

Growth Shares are sometimes issued at nominal value in practice if the issuance occurs within a short period of time (usually 3-6 months) following the last financing round and the hurdle amount is set at the highest issue price paid by investors in that round. In other words, if the Hurdle is set at the *pro rata* equity value of the start-up that was used to calculate the issue price of the preferred shares issued by the start-up in a very recent financing round, the fair value of the Growth Shares was in some cases set equal to their nominal value, *i.e.*, usually EUR 1.00 per Growth Share.

If one wants to go a step further, one might conclude that Growth Shares can be issued at their nominal value provided that the Hurdle is set at the company's current equity valuation. When no external price points from a financing round or similar arm's length transaction are available, the value of company should be determined by a third-party appraisal.

One might argue that an acquisition price equal to the nominal value of the Growth Shares might be too low:

- Since the Hurdle only becomes relevant in the future when the exit proceeds get distributed, its present value at the time of issuing the Growth Shares is lower (which would result in a higher fair value of the Growth Shares). This could be addressed – particularly for start-ups that already regularly generate profits – by making the Hurdle dynamic, as outlined above.
- Since start-ups regularly (still) do not generate ongoing profits, Growth Shares are frequently assigned an intrinsic option value which arises from a combination of actors (such as the company's current equity valuation, market volatility, the anticipated time frame until exit *etc.*) and does not necessarily match their nominal value.
- As of now, the tax authorities have not yet established a consistent position on the method for determining the fair value of Growth Shares and, consequently, their 'right' issue price. These uncertainties can be mitigated by involving a third party appraiser and maintaining close coordination with the tax authorities.

2.3 What to Put in the Articles of Association and Shareholders' Agreement

To avoid tax risks, we believe that the concept of Growth Shares should be regulated as such in the publicly accessible articles of association of the start-up, *i.e.*, that there is a class of shares burdened with a negative liquidation preference. The negative liquidation preference is then attached to the Growth Shares and is not linked to the specific shareholder as a person. Such personal circumstances would be irrelevant for the determination of the fair value. The "cooperative" effect of incorporating the concept of a negative liquidation preference into the articles of association directly applies to profit distribution and the distribution of liquidation proceeds. Additionally, for consideration in the distribution of sale proceeds in the event of a share deal, the negative liquidation preference needs to be reflected in the waterfall set forth in the shareholders' agreement.

In our opinion, the amount of the Hurdle itself does not need to be mentioned in the articles of association. This can be regulated in the non-public shareholders' agreement. However, it should be noted that some advisors hold that the Hurdle amount needs to be explicitly stated in the articles of association and some residual risks remain. In fact, our analysis of the articles of associations of more than 60 start-ups that had implemented Growth Share programs revealed that in a not immaterial number of cases the articles of association provided for a specific Hurdle amount (for details please see Chapter A.IV.2.5.).

2.4 Involving the Tax Authorities

Although Growth Shares have become more common in the market in recent years and their tax treatment has been tested at different German tax authorities, residual uncertainty still exists. The start-up and the Beneficiary have two options to reduce residual risks.

- One option for the start-up is to apply for a binding wage tax ruling (*Lohnsteueranrufungsauskunft*, cf. sec. 42e EStG) regarding the initial non-taxation with wage tax and the non-application of wage tax on future capital income from the Growth Shares. In terms of timing, obtaining a wage tax ruling can take several months (depending on the competent tax office), and the Growth Shares may not be issued during this period if one wishes to keep options open for adjustments that would avoid the incurrence of wage tax.

  Note that an affirmative wage tax ruling will provide comfort to the start-up regarding the wage tax treatment but will not secure the income tax treatment at the Beneficiary's level, though experience tells us that the tax authority responsible for the Beneficiary will often follow the views taken by the tax authority responsible for the start-up's wage taxes.

- For further certainty beyond the wage tax treatment, a binding tax ruling (verbindliche Auskunft, cf. sec. 89 AO) can be obtained by the start-up or Beneficiary (in the latter case in addition or alternatively to the wage tax ruling by the start-up). However, such a binding tax ruling—unlike a wage tax ruling—is subject to a fee[5] and can often take even longer than a wage tax ruling. Additionally, a binding ruling may only be issued if the relevant tax facts have not yet been realized (*i.e.*, before the granting of Growth Shares). In cases with several Beneficiaries, (theoretically) each Beneficiary would need to obtain a separate binding tax ruling to benefit from the binding effect and depending on where the Beneficiaries live, different tax authorities will be competent.
- Alternatively, the start-up merely discloses the circumstances after issuance of the Growth Shares, setting off tax compliance obligations towards the tax authorities. However, such an approach would not eliminate the remaining risk of a later tax payment which is usually subject to interest, for example, due to a tax audit.

2.5 DAC-6

The start-up should also consider that if Growth Shares are granted to beneficiaries that are not tax-residents in Germany, a notification and disclosure requirement under the DAC-6 regime might apply, which must be fulfilled either by the start-up itself or its advisor. Failure to fulfill this obligation has no immediate tax consequences but can be sanctioned by the imposition of fines.

5. The amount of the fee is based on the potential income tax on the monetary benefit within the framework of the issuance of the employee participation.

3. VESTING AND LEAVER PROVISIONS

It is characteristic with employee participation programs that the participation is only offered to key executives, cannot be freely transferred to third parties and can be called (in whole or in part) if the Beneficiary ceases to be actively involved in the start-up prematurely, with the call option price varying based on the reasons for the Beneficiary's leaving. The question arises whether the stipulation of such terms for a Growth Share program could subject the acquisition of Growth Shares or any proceeds resulting from Growth Shares to wage taxation.

This issue arises, whether the implementation of such rules for Growth Shares inevitably causes the acquisition of Growth Shares and, if applicable, the income generated from them to be subject to wage tax. According to the case law of the financial courts, such a qualification is not necessarily appropriate. Rather, a comprehensive assessment of all of the circumstances is necessary to determine whether the capital participation is motivated by the employment relationship or if an independent "special legal relationship" exists. For the latter, it is particularly important whether the capital participation is acquired at fair value, as previously mentioned, whether the Beneficiary bears an effective risk of loss and whether the structuring of the capital participation is customary.

In particular, the BFH in the previously cited judgments dated December 14, 2023 (VI R 1/21 and VI R 2/21) ruled that contractually agreed vesting provisions do not preclude recognition as a "special legal relationship" outside the scope of wage tax. According to the BFH, such clauses are common. Although they link the participation relationship to the continuation of the employment relationship, they do not deprive the participation of its independent legal character.

Against this backdrop, it is common for Growth Shares to be subjected to vesting provisions. Put simply, vesting means that the Growth Shares must be earned by the Beneficiary over time. (In simplified words:) The vesting schedule is the timetable over which a Beneficiary accrues the right to keep the Growth Shares that have been awarded. Vesting is a standard feature of employee ownership programs, and it also protects the start-up. It stages the economic accrual of Growth Shares while mitigating the risk that a Beneficiary will depart with an undeserved stake in the company. It emphasizes the retention element as it continually incentivizes the Beneficiary as they earn their Growth Shares package over the course of the vesting period. The company can also impose performance or other conditions on the Beneficiary's retention of their Growth Shares, although in our experience, most parties stick to the typical time-based vesting.

The vesting and leaver provisions in Growth Share programs are comparable to those in general employee participation programs (in Germany, particularly VSOPs) but naturally includes elements of founder vesting schemes. Specifically, this means:

Scope of Vesting: When Growth Shares are allocated to Beneficiaries who are newly entering the start-up or when existing employees get an equity allocation for the first time, all Growth Shares are typically subject to vesting. A different arrangement may be agreed upon if Growth Shares are allocated to founders to (partially) compensate them for excessive dilution that occurred in the past. In such cases, the parties may agree that the same vesting rules apply to the Growth Shares as to the other common shares of the founders. Depending on the financing stage of the start-up and the relative bargaining power of the parties, a portion of the shares may be exempted from vesting.

Vesting Period and Cliff: The vesting clauses in the Growth Share program usually provide for a call-option to be granted by the Beneficiary to the Company and / or the (then-existing) shareholders, or a third party nominated by the shareholders (*e.g.*, a new Beneficiary) to acquire all of their unvested Growth Shares in case of a good leaver event (*i.e.*, the leaving Beneficiary can keep the vested Growth Shares).

In addition, the vested Growth Shares will usually be subject to the call option in bad leaver cases, while call-options for vested Growth Shares in good leaver cases are rare (and then they usually foresee a purchase price equal to the Growth Shares' fair value at the time of the leaver). The call-option can be structured as an irrevocable offer by the Beneficiary, which then only needs to be accepted by the respective call-option beneficiary in the required form (a so-called self-executing call-option). This will give the company and its shareholders a higher level of comfort, as the shares are automatically transferred upon the acceptance. Such self-executing call-options require careful drafting so that the acting notary is comfortable to actually file an updated shareholders' list with the commercial register of the company after the call-option has been exercised.

In most Growth Share programs, a three- to four-year monthly (only occasionally quarterly) vesting schedule with a (fully or partially) accelerated vesting upon the occurrence of an exit event are standard. However, the details are subject to negotiation, and different Beneficiaries can have different vesting schedules.

In particular for Beneficiaries who get their first equity participation in the start-up, Growth Share programs also usually include a so-called "cliff". The Beneficiary must remain with the company for at least the duration of the cliff for the first tranche of their Growth Shares to vest (*i.e.*, to be accrued and then become nonforfeitable). Cliff periods range from 6 to 24 months with most of them centering around 12 months.

Note that it is same for founders in follow-on financing rounds, investors may ask for a part of the vested Growth Shares to become unvested Growth Shares again and for the vesting schedule to be adjusted accordingly to ensure the continued commitment by the founders and Beneficiaries alike. We see these requests in particular for Growth Shares allocated to late co-founders or where a larger allocation of Growth Shares is made to a Beneficiary who is considered key for the future success of the start-up.

Good Leaver and Bad Leaver: Leaver events let the vesting stop and result in at least a portion, or possibly all, of the Growth Shares having to be returned at a purchase price that may be higher or lower, depending on the type of leaver event. Leaver events are regularly linked to the termination of a Beneficiary's managing director service agreement, consultancy agreement or employment contract (as the case may be) or revocation of the Beneficiary's appointment as managing director of the company.

Some typical examples of good leaver events are:

- the contract or appointment as managing director is terminated / revoked by the company other than for good cause;
- the Beneficiary terminates his contract or resigns from his appointment as managing director for good reason;
- death of the Beneficiary; or
- permanent disability of the Beneficiary.

Bad leaver events are usually given if:

- the contract or appointment as managing director is terminated / revoked by the company / shareholders' meeting for good cause, in particular, if the Beneficiary is responsible for such good cause; or
- the Beneficiary terminates his contract or resigns from his appointment as managing director without good cause.

Although this can make the whole vesting question even more complex, sometimes it makes sense to also provide for a so-called grey leaver clause for events that straddle the good leaver / bad leaver divide. The typical case for a grey leaver is that the Beneficiary terminates his contract with the company or resigns from his appointment as a managing director after a certain minimum period (*e.g.*, two years) without good reason, but hasn't done anything that would justify treating him as a "typical" bad leaver. The grey leaver provision may provide that the Beneficiary can keep a certain portion of his vested Growth Shares (instead of all, as in the case of a good leaver) rather than lose all of them (in case of a bad leaver).

Call Option Purchase Price: While we see a variety in the market and often more nuanced approaches, typical call-option prices are:

- In case of a bad leaver: the lower of the acquisition price paid by the Beneficiary for the Growth Shares or the then-applicable fair value of the Growth Shares, irrespective of whether or not the Growth Shares were vested or unvested.
- In case of a good leaver: the acquisition price paid by the Beneficiary for the unvested portion of the Growth Shares and in case that the call-option also applies to the vested portion of the Growth Shares the higher of the acquisition price paid for the vested Growth Shares or then-applicable fair value of the vested portion of the Growth Shares.

Accelerated Vesting: Growth Share programs are designed to incentivize and retain key individuals within a company by granting them equity that vests over time. One common feature of these programs (as well as other employee participation programs) is the provision for accelerated vesting in the event of an exit occurring before the regular vesting schedule is complete. This ensures that Beneficiaries can fully realize the value of their Growth Shares in that exit event. There are two primary types of accelerated vesting: single-trigger and double-trigger acceleration, each has its own set of advantages and disadvantages.

Single-trigger acceleration occurs when the vesting of Growth Shares is automatically accelerated upon the occurrence of an exit event. This type of acceleration is straightforward and provides immediate liquidity to Beneficiaries for all of their Growth Shares, which can be particularly attractive to key executives and employees who have contributed to the company's success. However, it may also lead to potential downsides, such as the risk of losing key talent post-exit, as individuals may leave the company once they have received the full purchase price on all their Growth Shares (and not only the vested portion as would be the case without an accelerated vesting scheme). This could be detrimental to the company's ongoing operations and integration post-acquisition, and in turn, make the M&A process more complex.

Double-trigger acceleration, on the other hand, requires two events to occur for vesting to accelerate: an exit event and a subsequent qualifying event, such as the Beneficiary staying onboard for a period of usually 12 months after the exit and not getting terminated for cause or terminating himself without good reason. This approach provides a balance by protecting employees who might otherwise be adversely affected by the exit, while also encouraging them to remain with the company during the transition period. The downside is that it can be more complex to administer and may not provide the immediate liquidity that some Beneficiaries desire.

In our experience, the use of double-trigger vesting for founders is still relatively rare for founders, but somewhat more common when it comes to key executives. In the United States, there is a stronger preference for double-trigger acceleration provisions especially by investors.

When considering whether to apply single- or double-trigger acceleration to Growth Shares, it may be appropriate to distinguish between different types of Beneficiaries. For founders and late co-founders, who are often deeply invested in the long-term success of the company, double-trigger acceleration might be more suitable as it aligns their interests with the company's continued success post-exit. For "normal" Beneficiaries, single-trigger acceleration could be more appropriate, offering them immediate rewards for their contributions and taking German market usances into account (though in our opinion, double-trigger acceleration schemes are on the rise in German ESOPs and VSOPs as well).

4. ADDRESSING THE PERSISTENT GOVERNANCE ISSUES

As already mentioned, there are two structuring alternatives for the issuance of Growth Shares:

- direct issuance / transfer of Growth Shares to the Beneficiaries; and
- indirect issuance / transfer of Growth Shares to the Beneficiaries who are pooled in a ManCo.

4.1 Direct Issuances

One should keep in mind that, from the start-up's perspective, there are some general potential issues that need to be considered whenever shares are issued to Beneficiaries who are not pooled through a ManCo but will hold such shares:

- in case of Growth Shares, directly or indirectly through their own holding entities (both options are available for Growth Shares); or
- in case of sec. 19a EStG shares, directly (only option for the sec. 19a EStG shares as they cannot be acquired through a personal holding entity).

Having Beneficiaries end up as shareholders of the start-up comes with a variety of potential issues. 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.

Shares in the start-up come with certain statutory rights irrespective of the size of the shareholding, including a comprehensive right to information (sec. 51a GmbHG), a right to participate in shareholders' meetings and the right to challenge shareholders' resolutions. 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.

In addition, if the start-up is a venture capital-backed start-up, all shareholders of the start-up need to become a party to the customary investment agreement and shareholders' agreement that are executed / amended in every financing round. So, the more shareholders there are on the cap table, the more complex and time-consuming the negotiations and the signing process can become.

Against this background, Growth Shares are typically issued directly to a very limited number of Beneficiaries. Once the number of intended Beneficiaries exceeds a range of about 3 to 5, they are usually pooled in a ManCo.

4.2 The Use of ManCos – Higher Costs but Simpler Governance

Pooling the Beneficiaries (or their holding entities) in a ManCo does increase the effort required to set up and operate the Growth Share program, but it can largely mitigate the aforementioned potential corporate governance issues.

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 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 ManCo qualifies as a non-commercial partnership (*vermögensverwaltende Kommanditgesellschaft*) for German tax purposes.

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 EStG shares) or directly or indirectly through their own holding entities (both options are available if the ManCo is meant to hold Growth Shares).

The Beneficiaries do not become direct shareholders in the start-up, *i.e.*, shareholder rights vested in the Growth 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).

This structure is more complex than the direct issuance of Growth Shares, although it scales better by pooling the Growth Shares in a ManCo controlled by the founders and investors. The ManCo (including the general partner and the managing limited partner) needs to be set up and maintained (this includes providing it with sufficient funding for its ongoing operation and administration). If a ManCo is to be used, special attention is needed on the question of where the Growth Shares being held by the ManCo come from. The corporate and tax considerations can become rather complex and should be reviewed on a case-by-case basis.

5. THE SALE OF GROWTH SHARES AND THEIR TREATMENT IN CASE OF AN IPO

5.1 Growth Shares in Case of an Exit – Who shall be Entitled to the Hurdle?

To hear it once more from every lawyer's favorite superhero, Captain Obvious: Only after the Hurdle is surpassed do the Growth Shares start participating in the distribution of exit proceeds. In case of an exit, the share purchase agreement will usually stipulate a purchase price for each share in the start-up that gets sold irrespective of what the sellers (*i.e.*, the start-up's shareholders) have agreed upon internally regarding the positive or negative liquidation preferences. In a second step, the sellers will usually instruct the buyer to make payments to them according to the distribution of the exit proceeds following the allocations of positive liquidation preferences (if relevant) and the negative liquidation preferences for the Growth Shares.

But how does the Hurdle amount get distributed among the holders of "normal" shares, *i.e.*, non-Growth Shares?

- The simpler option is to distribute it amongst all other shareholders participating in the respective liquidity event on a *pro rata* basis.
- Another option is to allocate the Hurdle to those parties that were shareholders at the point in time when the Growth Shares were issued. Given that such shareholders might have transferred some shares or left the start-up altogether since that time, it is simpler to allocate the Hurdle Amount to the non-Growth Shares existing at the point of time when the Growth Shares are issued. A common variation of this approach is to allocate the Hurdle only to the holders of common shares.

Depending on the amount of the Hurdle and the development of the start-up's share number after the issuance of the Growth Shares, the distribution of the Hurdle amount can significantly impact the stakeholders involved. The first option, distributing the Hurdle amount on a *pro rata* basis among all shareholders participating in the liquidity event, is straightforward, (arguably) equitable and easier to model in the waterfall.

This method ensures that all current shareholders benefit proportionally to their ownership, reflecting the current state of the company's equity structure. However, depending on how the fully-diluted share price for the investors who acquired their shares after the issuance of the Growth Shares, this approach may not fully recognize the contributions of early investors who took on more risk by investing before the issuance of Growth Shares.

Occasionally we have come across a third hybrid approach that combines elements of the two methods described above. For instance, the Hurdle amount could be split, with a portion distributed *pro rata* among all current shareholders and another portion allocated to those who were shareholders at the time of the Growth Shares issuance (or, easier, from an administration perspective, to the outstanding shares at the time of the issuance of the Growth Shares—for those unfamiliar with the German law for GmbHs: shares in a GmbH are assigned a specific consecutive number that is shown in the publicly available shareholders' list). This method attempts to balance the recognition of early risk-taking with the simplicity and fairness of a *pro rata* distribution. It acknowledges the contributions of early investors while also considering the current equity structure. This approach, however, may require more complex calculations and clear communication to ensure all parties understand and agree with the distribution rationale.

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 the favorable taxation of capital income. Likewise, the taxation of capital income shall also be applicable for the redistributed Hurdle allocated to the shareholders that stand to benefit from such reallocation. In case of an exit via an asset deal and a subsequent distribution of proceeds, the start-up's articles of association need to provide for the option of a disproportionate distribution of proceeds by unanimous shareholders' resolution (the start-up's shareholders' agreement will obligate all shareholders to unanimously resolve a distribution of the available proceeds according to the positive and negative liquidation preferences).

5.2 Sale of Growth Shares Outside an Exit Event

The shareholders' agreement should also provide for provisions on how to deal with the sale and transfer of Growth Shares outside of an exit event, for example, if Beneficiaries shall be allowed to divest some of their Growth Shares as part of a secondary share sale. A customary provision could foresee that the Beneficiary as a seller of the Growth Shares shall either (i) sell and transfer the Growth Shares as such, *i.e.*, with the negative liquidation proceeds attached and continuing to apply (if there have been distributions, they will reduce the (remaining) Hurdle) or (ii) sell and transfer the Growth Shares with the provision to be converted into common shares upon such sale by either transferring such part of the purchase price up to the Hurdle to the shareholders who shall be entitled to the Hurdle (see above) or procuring that the respective acquirer directly pays such part of the purchase price up to the Hurdle to such shareholders. Upon occurrence of such a sale and receipt of the full Hurdle by the entitled shareholders, the negative liquidation preference shall be satisfied and the sold Growth Shares shall be converted into common shares at a ratio of 1:1.

5.3 Growth Shares in Case of an IPO

Even though an IPO will never be relevant for most start-ups, it is an interesting question (No, we indeed don't have a lot of hobbies. Why are you asking?) what should happen to the Growth Shares in the event of an IPO. Growth Shares cannot be listed and therefore must be "converted" into common shares (similar issues arise with an indirect listing, where the start-up is first contributed to a (foreign) holding entity better suited for listing in exchange for shares, and this holding entity then goes public).

However, due to the Hurdle, one Growth Share does not economically equate to one common share, which means a simple 1:1 conversion is not possible if the Hurdle has not been satisfied beforehand. The situation here is different from that of preferred shares. IPOs usually occur at a valuation above the (applicable) positive liquidation preferences, allowing preferred shares to be converted into common shares at a 1:1 ratio.

For Growth Shares, there are various approaches to handle an economically non-parity exchange ratio, such as a combination of an initial 1:1 conversion, followed by the redemption of a portion of the common shares thus created or their transfer to the shareholders benefiting from the Hurdle.

IV. Empirical Data on Growth Shares

In this Chapter, we will share findings of a limited empirical study of Growth Share programs in German start-ups.

1. THE ANALYZED DATA SET, ASSUMPTIONS AND LIMITATIONS

In a prior edition of OLNS, we have published the findings of our "OLNS Board Study 2024/2025"[6], in which we examined the prevalence, composition and development of advisory boards in German start-ups across multiple financing rounds. As a basis for that survey, we have used data from the service provider PitchBook to create a set of start-ups headquartered in Germany. We applied the following search criteria: (i) all VC stages from Angel & Pre / Accelerator / Incubator, Seed, Series A, Series B, Series C, Series D and Series E, (ii) in the region of Germany, and (iii) for the period from January 1, 2018, to July 8, 2024. We then limited the search to the deal status "completed".

For the resulting data set of companies, we obtained copies of their current and prior articles of association from the electronic commercial register at www.handelsregister.de. From these PDF and TIFF files, we then searched for indications of Growth Shares using document processing techniques (our prompts took into account the various designations of Growth Shares in practice, such as Hurdle Shares, NLP Shares, *etc.*).

If the articles of association contained provisions on Growth Shares, the relevant shareholders' lists were additionally obtained from the electronic commercial register. To qualify as the (indirect) acquirer of the Growth Shares as a key employee, late co-founder, or similar, a desktop search was then conducted, with particular reliance on information from the career network LinkedIn.

We are well aware that both the underlying data set, as well as our approach in assessing it, are far from perfect and leave plenty of room for further future research.

Below we list what we believe are the most important limitations to be aware of when interpreting our results.

- Our analysis is limited to the start-ups recorded in the PitchBook database. Even though we believe that the quality of this and similar databases for the situation in Germany has improved in recent years, the overall coverage level for Germany does not yet match the quantity and quality of the situation in the United States. Our data set surely only represents a small portion of the reality of German start-up land.
- Our analysis is generally limited to start-ups that have received external funding. As PitchBook and other service providers do not claim to cover all start-ups in a country, one should be cautious to extrapolate our findings to the broader (non-investor focused) start-up ecosystem in Germany.
- Even though we were involved in quite a few of the Growth Share programs we examined (if that sounds like shameless self-promotion to you, we suggest you trust your instincts...), we limited our analysis strictly to the information available from the electronic commercial register and a PitchBook database query.
- Whether Growth Shares need to be anchored in a start-up's articles of association or whether a provision in the shareholders' agreement is sufficient is not uniformly assessed in practice. From our perspective, the articles of association should provide for a separate class of shares and foresee the negative liquidation preference (at least the concept as such, but maybe also the specific Hurdle(s)). However, it is also argued that a negative liquidation preference that is only stipulated in the shareholders' agreement reduces the value of the respective shares if the articles of association contain a typical transfer restriction clause and the shareholders' agreement makes the granting of consent for share transfer contingent upon the acquirer joining the shareholders' agreement and thereby agreeing to the provisions on the negative liquidation preference. May that as it be, our analysis of publicly available documents from the commercial register was only able to identify start-ups where Growth Shares were defined as such in the articles of association. Accordingly, our analysis only captures a more or less small portion of the actual Growth Share programs in the German market.
- From the reviewed articles of association, the financing stage was not apparent in a few cases. We then relied on the classification by PitchBook, but one should be aware that a misclassification cannot be excluded.

6. See OLNS#12 "Advisory Boards in German Start-ups", the Guide can be downloaded here: https://www.orrick.com/en/Insights/2024/11/Orrick-Legal-Ninja-Series-OLNS-12-Advisory-Boards-in-German-Startups.

2. FINDINGS

2.1 Total Numbers and Naming

In total, we identified 66 companies whose articles of associations referred to some form of Growth Shares.

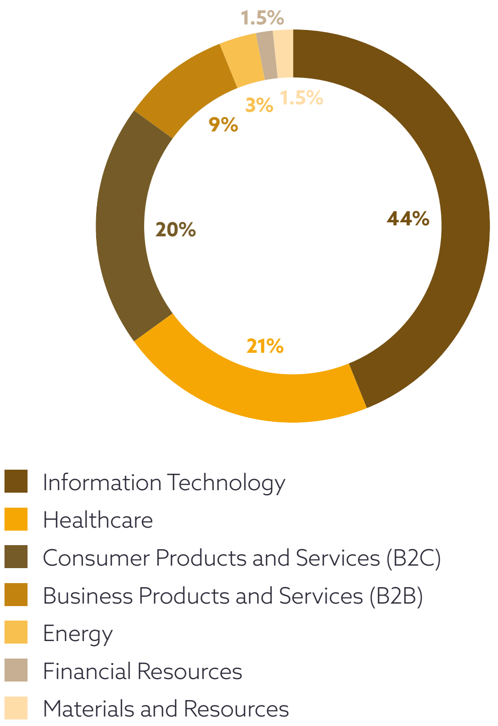
Half (33) of the companies used the term "Hurdle Shares". This is followed by 20 companies that used "NLP Shares". Seven companies referred to "Growth Shares", while two companies used the terms "Zero Shares" and "Subordinated Shares", respectively. One company uses the term "Management Shares", and another refers to this class of shares in their articles of associations as "Common Shares with Negative Liquidation Preference".

2.2 Which Companies Issue Growth Shares?

65 out of the 66 companies in our analysis are organized as limited liability companies (GmbH). Only one company is structured as a stock corporation (AG).

When examining the business sectors and industries of the companies in our data set, the following distribution emerges: The largest group, comprising of 29 companies (approx. 44%), belongs to the "Information Technology" sector. This is followed by the "Healthcare" sector with 14 companies (approx. 21%). Next is the "Consumer Products and Services (B2C)" sector, which includes 13 companies, making up about 20%. "Business Products and Services (B2B)" follows with six companies (approx. 9%), while the "Energy" sector includes two companies (approx. 3%). Lastly, there is one company each in the "Financial Resources" and "Materials and Resources" sectors (each approx. 1.5%).

DISTRIBUTION GROWTH SHARE PROGRAMS PER SECTOR (N=66)

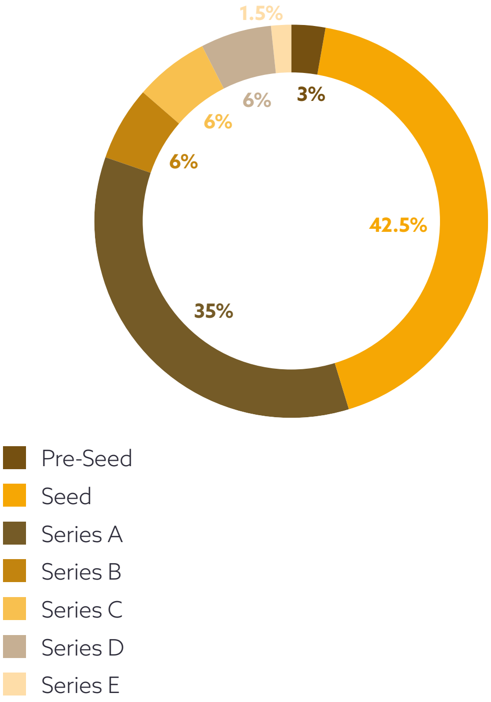


2.3 In which Stage are Growth Shares Issued?

We also looked at the financing stage of the companies when they issued Growth Shares for the first time (when they issued Growth Shares at various points in time, we considered the first issuance to be the relevant one for our categorization).

Of the 66 companies in our data set, 28 (approx. 42.5%) had raised a Series Seed as their last financing round when they issued Growth Shares. Another 23 companies (approx. 35%) were in Series A. Four companies (approx. 6%) were in Series B, Series C and Series D stage, respectively. Two (approx. 3%) were in Series Pre-Seed, and one company (approx. 1.5%) was in Series E.

DISTRIBUTION GROWTH SHARE PROGRAMS PER FINANCING STAGE (N=66)

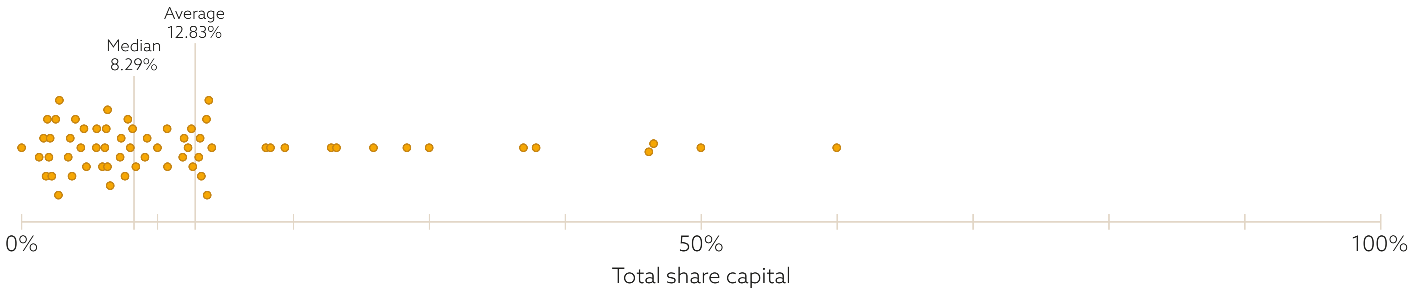


2.4 How Many Growth Shares are Issued?

We also looked at the proportion of Growth Shares issued relative to the total share capital of the company at the time of issuance. For this, we compared the number of Growth Shares to the total number of shares in the start-up immediately after the issuance of the Growth Shares. If the articles of association only provided for an authorized capital for the Growth Shares, we assumed, for better comparability, that the authorized capital was fully utilized immediately and a corresponding number of Growth Shares were issued. In the few cases where a start-up issued on various occasions (different classes of) Growth Shares, we used the figures from the first issuance of Growth Shares.

Among the 66 companies examined, the smallest percentage of initially issued Growth Shares was 0.00027%. The highest percentage was 60%. On average, 12.83% of the share capital was issued as Growth Shares, with a median of 8.29%. The following graphic illustrates the distribution we found:

SIZE OF GROWTH SHARE PROGRAMS AS % OF SHARE CAPITAL (N=66)



2.5 Who Gets Growth Shares?

From a conceptual perspective, the granting of Growth Shares is particularly considered to:

- reverse (excessive) dilution of the initial founders;
- incentivize additions to the initial founder team who joined the company at a later point in time or replaced one of the initial founders;
- incentivize other key executives of the start-up outside the founder team, and other key contributors (such as board members); or
- investors.

However, in practice, the distinction between founders, late co-founders and key executives is, of course, fluid, and statements on the company's website or on career networks like LinkedIn often serve the company's founding narrative or reflect more personal marketing. Additionally, we have occasionally observed that Growth Shares were initially "parked" with a ManCo or sometimes with the company itself (*e.g.*, when it acquired shares from departing Founders and reclassified them as Growth Shares). If the Growth Shares were held by the company itself, we therefore assumed that they are intended for key executives outside of the founding team. In this case, we have allocated the Growth Shares to this group. In our desktop research, we aimed for the most accurate categorization possible, but in cases where shares were allocated to a ManCo, we assumed a (later) allocation to key executives in case of doubt. Furthermore, some of the programs are quite recent, so in some cases, we do not yet know how many Beneficiaries there will ultimately be.

With this in mind, our preliminary analysis yielded the following results:

Number of Beneficiaries: On average, Growth Shares were granted to 1.7 Beneficiaries. The range spanned from ten Beneficiaries to just one Beneficiary.

Categorization of the Beneficiaries: We also attempted to categorize the recipients. For this classification, we relied not only on commercial register information but also on other sources such as the companies' websites and the LinkedIn profiles of the Beneficiaries. We understand that the distinctions are fluid and that the categorization is, of course, somewhat subjective (which is lawyers' Latin for arbitrary). We distinguish the following categories:

- **Founder:** This refers to members of the original founding team. We suspect that the allocation here was either to compensate for excessive dilution of the Founders in early financing rounds or to retrospectively increase an initially insufficient allocation of shares to a member of the founding team.
- **Late Co-Founder:** This refers to a person who joined the founding team later but is seen as a Founder due to their capital participation, particularly prominent role, *etc.*
- **Key Executives:** This category includes particularly relevant employees of the company who are neither Founders nor Late Co-Founders.
- **Investors:** This group includes the company's financiers who are not operationally involved in the company.
- **Others:** This group includes other Beneficiaries who were allocated Growth Shares, such as advisory board members or other consultants.

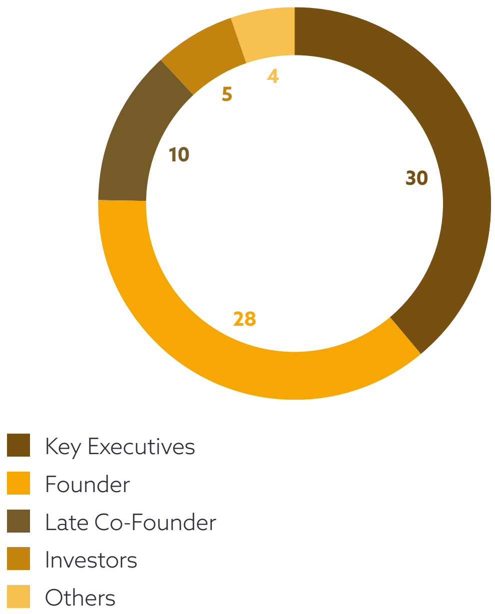
For simplicity, we assumed that in case of allocations to a ManCo (as well as in cases of Growth Shares warehoused by the company), the intended Beneficiaries were key executives, as founders that are already shareholders in the company (so there is no need for a ManCo), and late co-founders, due to the desire to appear as "normal" Founders externally, will typically value direct participation in the start-up.

Furthermore, in many cases, companies issued Growth Shares to multiple Beneficiaries who belonged to different categories, resulting in multiple entries.

With this in mind, the empirical findings are as follows:

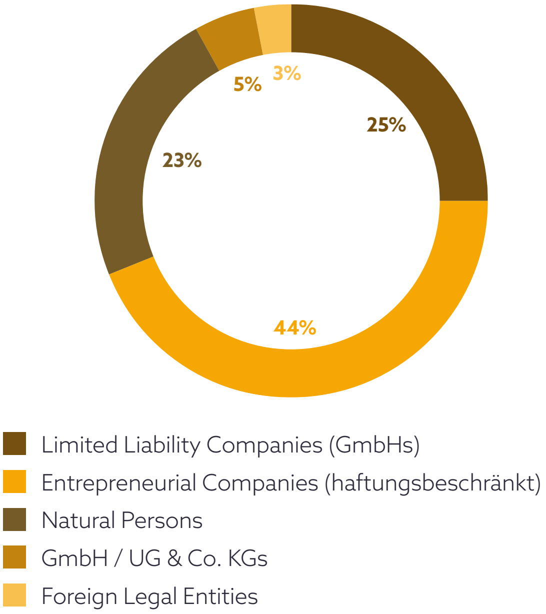
In 30 cases, Growth Shares were issued to Key Executives, with four of these allocations made through a ManCo. Founders received Growth Shares in 28 cases. The "Late Co-Founder" category accounted for ten allocations of Growth Shares, although, as mentioned, the distinction between Founder and Late Co-Founder is not clear-cut. Investors received Growth Shares five times. In the "Others" category, we recorded four allocations, where recipients included, among others, advisory board members (including the advisory board chairman) and nonvoting observers on the advisory board.

BENEFICIARIES UNDER GROWTH SHARE PROGRAMS (N=77)



Acquisition by Corporations and Partnerships:
On the acquirer side, we found 25% limited liability companies (GmbHs), 44% entrepreneurial companies (haftungsbeschränkt), 23% natural persons, 5% GmbH / UG & Co. KGs, and 3% foreign legal entities such as LLCs and B.V.s.

DISTRIBUTION OF ACQUIRING ENTITIES AND INDIVIDUALS



The predominance of Growth Share acquisition by legal entities is due to the fact that, for German taxpayers, this method reduces the initial tax burden to 1.5% of the proceeds exceeding the hurdle, assuming an attractive exit value, making Growth Shares the most tax-efficient form of participation. A cursory review of cases where a natural person acquired Growth Shares showed that a significant number of these individuals were located outside Germany (including the USA and UK). Unlike German tax law, the tax laws in these countries do not encourage the acquisition of equity instruments through personal holding entities.

EMPIRICAL DATA ON HURDLES

#	Stage	Year of Implementation	Hurdle	Implied Company Valuation
1	Series Pre-Seed	2022	EUR 39.50	EUR 1,000,000
2	Series Pre-Seed	2021	EUR 300.44	EUR 14,000,000
3	Series Seed	2023	EUR 34.22	EUR 1,500,000
4	Series Seed	2019	EUR 99.00	EUR 2,500,000
5	Series Seed	2023	EUR 99.78	EUR 13,900,000
6	Series Seed	2023	EUR 130.33	EUR 2,900,000
7	Series Seed	2021	EUR 132.80	EUR 4,000,000
8	Series Seed	2022	EUR 142.96	EUR 9,700,000
9	Series Seed	2024	EUR 403.40	EUR 15,000,000
10	Series Seed	2023	EUR 444.60	EUR 18,800,000
11	Series Seed	2020	EUR 500.82	EUR 19,500,000
12	Series Seed	2022	EUR 667.90	EUR 23,000,000
13	Series A	2019	EUR 39.00	EUR 1,100,000
14	Series A	2022	EUR 79.76	EUR 29,000,000
15	Series A	2023	EUR 134.17	EUR 6,400,000
16	Series A	2022	EUR 140.08	EUR 7,800,000
17	Series A	2021	EUR 199.69 EUR 479.71	EUR 19,000,000 EUR 46,500,000
18	Series A	2023	EUR 361.01	EUR 12,400,000
19	Series A	2022	EUR 412.79	EUR 100,000,000
20	Series A	2021	EUR 422.70	EUR 29,400,000
21	Series A	2022	EUR 1,000.00	EUR 71,100,000
22	Series A	2024	EUR 1,391.86	EUR 87,000,000
23	Series A	2019	EUR 2,311.14	EUR 58,000,000
24	Series C	2019	EUR 72.60	EUR 1,800,000
25	Series C	2020	EUR 2,481.04 EUR 3,101.30 EUR 3,700.00 EUR 4,400.00	EUR 185,500,000 EUR 232,000,000 EUR 277,000,000 EUR 329,000,000
26	Series C	2023	EUR 6,588.06	EUR 756,000,000
27	Series D	2022	EUR 4,603.55	EUR 1,100,000,000
28	Series D	2021	EUR 13,501.53	EUR 1,100,000,000

2.6 Findings on Hurdle Amounts

In a total of 28 identified articles of association, a specific Hurdle was mentioned. In two cases, even multiple classes of Growth Shares with different Hurdle amounts were mentioned (in one case two and in the other case four classes). In three cases, the Hurdle was not specified as an amount per Growth Share but as a total amount. We then converted this into a Hurdle per Growth Share by dividing it by the number of the issued shares existing immediately before the issuance of the Growth Shares.

The sample size is too small for statistically reliable statements. Nevertheless, we want to present the results found in the table. The information regarding the Hurdle comes from the respective articles of association. We have supplemented the other data through our own research. We derived the "Implied Company Valuation" by multiplying the Hurdle mentioned in the articles of association by the number of shares issued immediately before the creation of the Growth Shares.

In addition, we noticed the following:

- In only one of the cases where the articles of association mentioned a specific Growth Share, the articles also provided for an interest on the Hurdle (interest rate 5.5% *p.a.*, including compound interest).
- In one case, the company's articles of association provide for a so-called "freeze" amount for the Growth Shares. Once the Hurdle is exceeded, the Growth Shares initially participate in distributions on a *pro rata* basis. However, once the freeze amount is reached, they only participate in further proceeds and distributions at 90%, while the remaining 10% that would normally be attributed to the Growth Shares is distributed among the other shareholders.
- In one case, the company's articles of association provide for an alternative Hurdle. The articles specify a particular Hurdle but also stipulate that if a new financing round is implemented by a certain date, the issue price of the new shares in this financing round shall serve as the Hurdle.

B. Our International Platform for Technology Companies

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

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

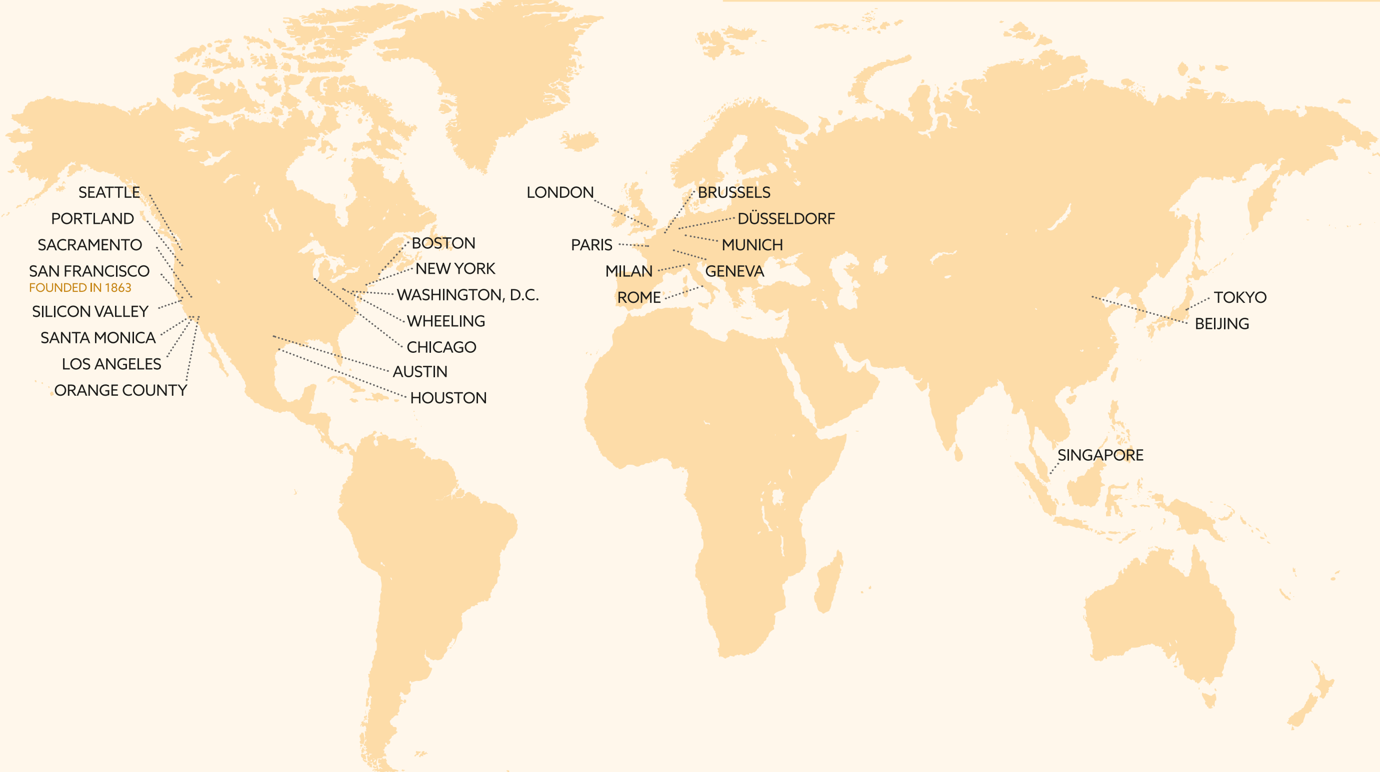
TDK Ventures
in its investment in Ineratec's €118 million Series B

Proxima Fusion
in its €20 million Series Seed

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

Taktile
in its $54 million Series B

80+ Flip Transactions
advised more than 80 German start-ups on getting into a U.S. / German holding structure and subsequent financings



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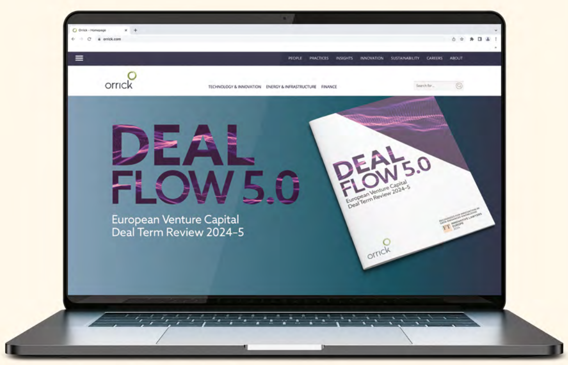

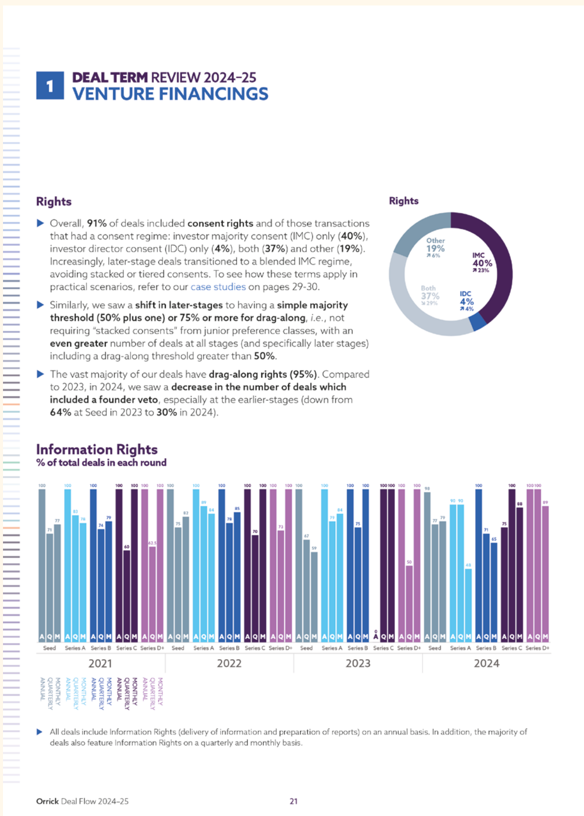

1 **DEAL TERM** REVIEW 2024–25
VENTURE FINANCINGS

Rights

- Overall, **91%** of deals included **consent rights** and of those transactions that had a consent regime: investor majority consent (IMC) only (**40%**), investor director consent (IDC) only (**4%**), both (**37%**) and other (**19%**). Increasingly, later-stage deals transitioned to a blended IMC regime, avoiding stacked or tiered consents. To see how these terms apply in practical scenarios, refer to our case studies on pages 29-30.
- Similarly, we saw a **shift in later-stages** to having a **simple majority threshold (50% plus one) or 75% or more for drag-along**, *i.e.*, not requiring "stacked consents" from junior preference classes, with an **even greater** number of deals at all stages (and specifically later stages) including a drag-along threshold greater than **50%**.
- The vast majority of our deals have **drag-along rights (95%)**. Compared to 2023, in 2024, we saw a **decrease in the number of deals which included a founder veto**, especially at the earlier-stages (down from **64%** at Seed in 2023 to **30%** in 2024).

Information Rights
% of total deals in each round

- All deals include Information Rights (delivery of information and preparation of reports) on an annual basis. In addition, the majority of deals also feature Information Rights on a quarterly and monthly basis.

Orrick Deal Flow 2024–25 21

Deal Flow 5.0

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

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Deal Flow 5.0 with our analysis of the 2024 deal terms is available at orrick.com/dealflow.

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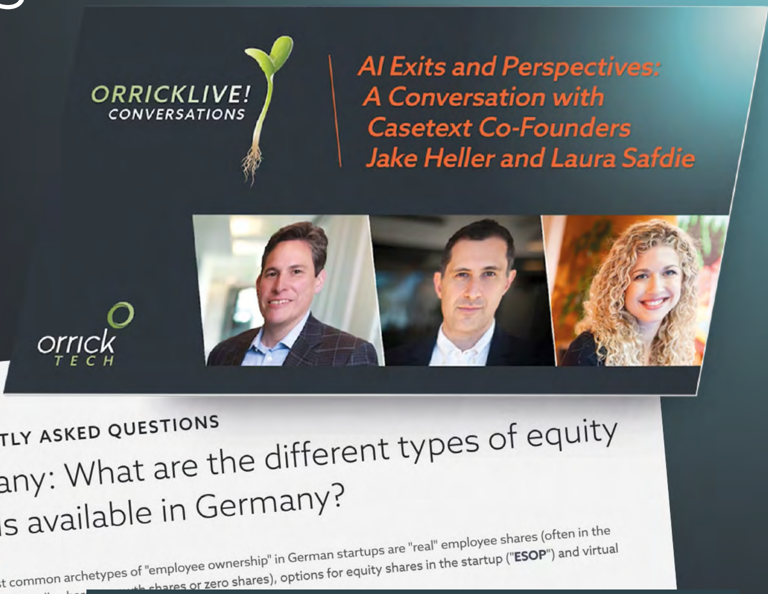

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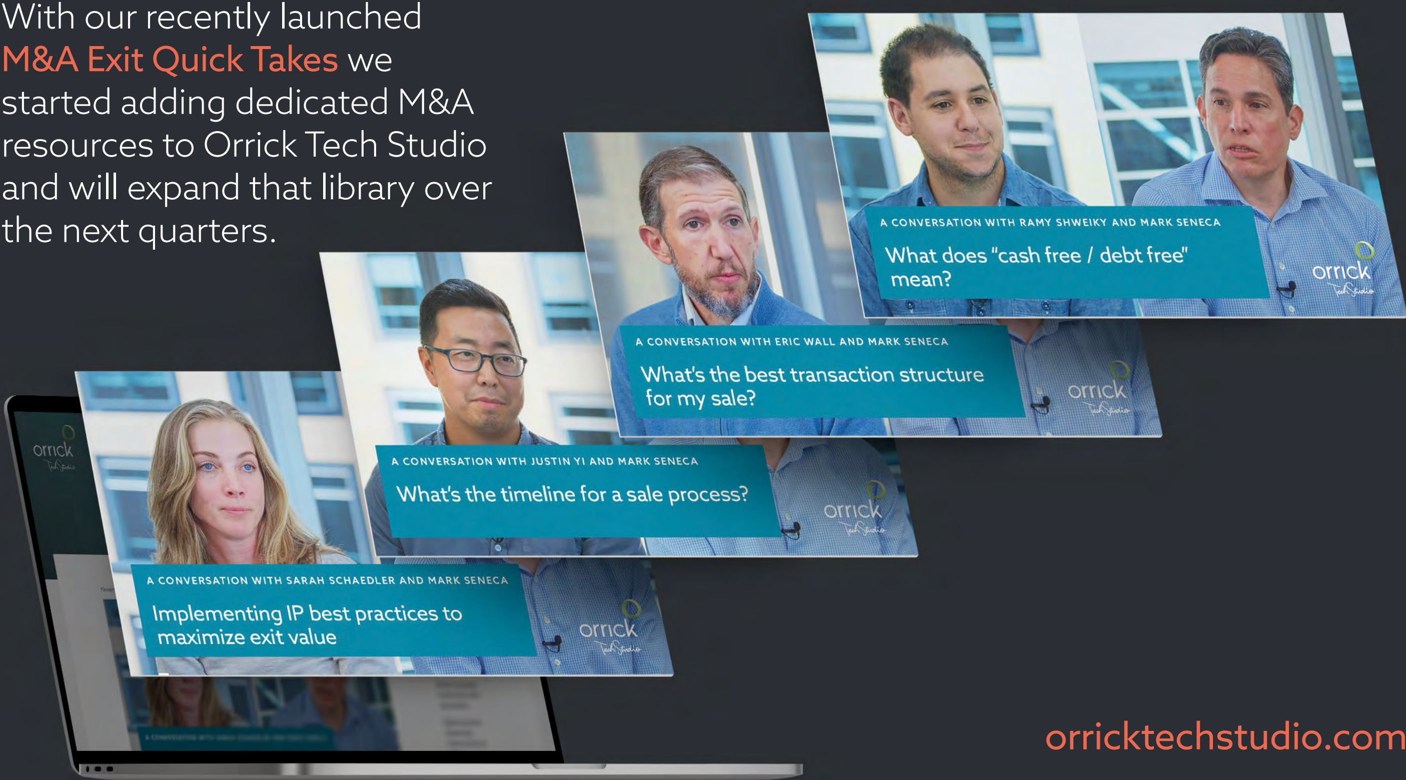
We've taken everything that we could make free, simple and inspiring about forming and scaling your company and loaded it into this online legal, regulatory and commercial studio.

With our recently launched **M&A Exit Quick Takes** we started adding dedicated M&A resources to Orrick Tech Studio and will expand that library over the next quarters.



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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

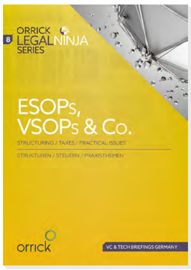
May 2020

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 #8 — ESOPs, VSOPs & Co.: Structuring / Taxes / Practical Issues

June 2021

OLNS#8 provides a comprehensive overview of equity-based and Employee-ownership programs (or in short "ESOPs") play a critical role in attracting and retaining top talent to fledgling young companies. Stock options reward employees for taking the risk of joining a young, unproven business. This risk is offset by the opportunity to participate in the future success of the company. Stock options are one of the main levers that start-ups use to recruit the talent they need; these companies simply can't afford to pay the higher wages of more established businesses. With OLNS#8, we want to help start-ups and investors alike to better understand what employee ownership is, structure them in a way that is congruent with incentives, and implement them cleanly.

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

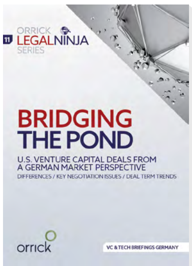
October 2021

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.

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.

Acknowledgements

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