# START-UP / VENTURE CAPITAL

## Dear Reader,

Yet again, the first two months of the year have just flown by. We are particularly happy to announce that we are now cooperating with both The Growth Stage and Werk1 in Munich.

The Growth Stage entered the market in autumn 2018 as the world's first financing platform for private growth companies. We have been working together with The Growth Stage as exclusive legal adviser since 31 January 2020 and assist companies when accessing institutional investors via this platform. (You can find the press release here.)

One of the reasons why the start-up Öko System in Munich has developed so well is the digital start-up center Werk1. In addition to two co-working spaces, Werk1 hosts an incubator, which focuses on digital start-ups of all industries, and the accelerator InsurTech Hub Munich in the fields of InsurTech and HealthTech. We decided to support Werk1 as a partner not only financially, but with our legal expertise, too. Our Werk1 Team is made up of experts for corporate law, labour law, IP/IT law and data protection law and it sponsors and supports Werk1 start-ups with workshops and regular office hours. Werk1 start-ups can also contact us at any time for advice and support.

You can find the following articles in this newsletter, together with our usual calendar of events:

- **Dr Gesine von der Groeben** from our Frankfort Office reports on the special features of M&A for start-ups.
- Our Hamburg colleague, **Jan Christian Eggers** addresses the question of when competition authorities will have a say in the sale of a start-up.
- Our experts for director liability, **Drs Daniel Walden** and **Florian Weichselgärtner** have analysed the liability risks for the directors of start-ups and the possibility of taking out D&O insurance as security against such risks. They also spoke to insurance expert Marcus Helmich from hendricks GmbH about this issue.
- **Tassilo Klesen** and **Dr Eva Kreibohm** look at the issue of "beneficial owner" and the new obligation on notaries to perform anti-money laundering checks – we should all have these checks on our radars in order to avoid unnecessary delays in notarisation.
- **Jan Mohrmann** from our Frankfort Office and **Christian Philipp Kalusa** from our Munich Office inform about their last experience with the design of an employee participation plan and the tax relevant points in time of valuation and receipt thereof.
- Our Munich labour law experts, **Drs Erik Schmid** and **Michaela Felisiak** clear up numerous misunderstandings about the question of "trial periods".
- Finally, **Frank Mayer** from Barmer Insurance provides some answers on the right health insurance for founders.

Happy reading!

We keep you up to date.

Your BEITEN BURKHARDT Start-up / Venture Capital Team

## Events

Of course, our events and workshops in the field of start-ups and venture capital will also take place in 2020. However, due to the current situation caused by the coronavirus, we may postpone the dates to the second half of the year. Therefore please check our website for the current dates. #flattenthecurve

BEITEN BURKHARDT

## A successful evening for entrepreneurs: "Startups & SMEs – a Perfect Synergy for the Future?!" in Frankfurt

In an evening event on 12 February 2020 in Frankfurt, which we organised together with the network for family businesses ALPHAZIRKEL International, about 60 interested people joined us in discussing the question "Startups & SMEs – a Perfect Synergy for the Future?!".

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## Thinking outside the box – M&A for start-ups

*Mergers & Acquisitions for start-ups – "Only for grown-ups" or the logical next step?*

It may sound contradictive for the founders of a young, innovative start-up to be thinking about merging with a competitor (mergers) or even acquiring a competitor if they have sufficient capital (acquisition). After all, such actions bring start-ups together with big companies much sooner, companies that might even want to "swallow" their smaller competitors. But is that really the case?

After some time (often a number of years), many founders reach a point where the time that they spend dealing with certain issues, which they really don't want to have to deal with or cannot do so in any detail, has become disproportionately high. Topics such as HR or compliance require ever greater attention with increased employee numbers and growing professionalism. The same is true for the planning and design of sales campaigns and for company accounting, which can no longer just be dealt with in passing at the end of the year. However, it is often not yet worth employing staff specifically to deal with these complex issues.

If there are also few prospects for growth, e.g. because the market for your products seems saturated or there are few new ideas, there can be no harm in broadening your focus to look at issues other than the development of your own company.

It is normal to keep an eye on your nearest competitors and in doing so you might discover that other start-ups or even established, medium-sized companies face very similar problems. You might even have the opportunity to discuss such issues, such as through special workshops for entrepreneurs or small and medium-sized companies, or through an incubator or a university.

If you can find a like-minded partner, there are significant opportunities for both: **utilise synergies!**

### IDENTIFY AND UTILISE SYNERGIES

What this will actually look like depends on the specific case. If a start-up has developed a system, for example, which simplifies the distribution and exchange of pharmaceutical products within and between hospitals, there are numerous possible synergies, for example from a merger with another start-up that:

- has developed a similar system for doctor's surgeries or pharmacies; this will significantly expand the market and provide new interfaces for exchanging the product;
- has developed a system, which is very similar on the whole; exchanging ideas can improve the system; in addition, it reduces the competition they face from one another;
- sells a similar system in a different country; both companies could extend their target markets;
- has developed a new type of system which significantly speeds up delivery and thus distribution or makes it particularly economical and/or environmentally-friendly.

### OPPORTUNITIES

Some of the resulting opportunities are clear. In addition to synergy effects, the opportunities include the injection of new ideas and people, or the merger of know-how. At the same time, expenditure for human resources, accounting and sales and marketing can be reduced when the new, co-developed entity is big and professional enough in its operations to employ specialists for each of these areas. Where there are already such personnel, there is potential for cost savings; the same is true for office rent, warehousing, etc.

### RISKS

You should also not lose sight of the risks. On the one hand, as with all decisions of such scope, there is significant economic risk for all parties involved. On the other hand, there can also be disadvantages to synergy effects. For example, your own start-up may no longer have the opportunity to expand into another country on its own, if the new merged entity or partner is already represented in that country.

It can be problematic on a personal level, too. This depends on how professional the relevant actors are. If the founders of two merging companies and both intend to implement their own ideas, they will have to be ready to compromise again and again. In some cases, this can go beyond just being exhausting. It can lead to a permanently negative atmosphere in the new company and even the breakdown of joint efforts. This happens particularly when the merger is between "equals", and less frequently in the case of an extremely costly acquisition of another company.

### AN EXAMPLE: MODOMOTO AND OUTFITTERY

Despite the risks, if you decide to merge with another company – whatever the form – the potential can be unexpected. A good example of this is the recent merger of well-known start-ups Modomoto and Outfittery at the end of 2019. Both companies sought to significantly increase their turnover, yet their cost savings have almost doubled.

### FINANCING

At an early stage, a close eye must be kept on any financing for this process. This is normal in the case of an "acquisition" of a competitor. However, it can also play an important role even in the case of a (pure) merger. The costs of advisors, registration changes, the drop in daily business while the transaction is prepared, etc. often cannot be borne by equity alone. In such cases, a bank or investor will be needed for financing. They will make a detailed assessment of the economic position of both companies, though there are no fixed rules as to which standards should be used to assess the value of a competitor, making it difficult for newcomers to penetrate this process. One simple yet imprecise method is the projection of the turnover of a company for a number of years.

In any case, the parties must set a purchase price, which will be used as a basis for determining the shares of the founders in the subsequent company. Often, it will be necessary to already pay out one of the founders at this stage, if the founder wishes to be released from the project.

In order to ensure the successful execution of the transaction – one of the cornerstones for success – some important aspects **must be observed:**

- Do your due diligence: Make a detailed legal and financial assessment of the other company, in order to be able to judge all the risks posed.
- At an early stage, consider what type of "merger" you want and can achieve – merger, joint venture, acquisition of the smaller competitor.
- Bring legal and tax advisors on board in good time.
- Possibly involve a M&A expert, who would assist with the search for and analysis of a suitable competitor and provide support during the whole process.
- Despite a high level of professionalism, the whole process can still take many months, during which time the daily business often takes a back seat.
- Strategically plan the timing of the merger. If it is too early in your company's own development, your risk stalling the regular business, which can impede the merger. Leave it too late, and it threatens to cause the company's whole development to stagnate.

To return to our original question: A merger of competitors is not always a "logical next step". However, it is even less true to say that it is "only for grown-ups". Simply, M&A offers both enormous potential for development for a start-up as well as risks that should not be underestimated – just like the establishment of a start-up itself.

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# The sale of start-ups – do competition authorities have a say?

In many cases, the sale of a start-up to an investor will not require prior notification to the *Bundeskartellamt* (German Federal Cartel Office) or other competition authorities. In most countries, whether the acquisition of an undertaking requires a notification depends on the turnover of the acquirer and the target. The requirement for notification to the *Bundeskartellamt* is unlikely to be triggered when the total turnover of the target company is below EUR 5 million. However, even if the target's turnover does not exceed this threshold a notification will be necessary when the transaction volume – i.e. primarily the agreed purchase price – exceeds EUR 400 million. A transaction volume trigger also applies for merger control in Austria (here the threshold is EUR 200 million). The fulfilment of other conditions may also trigger a notification requirement under the merger control laws of other countries, regardless of the turnover of the companies involved: in Spain and Portugal, for example, it will be triggered when the market shares of the undertakings involved exceed certain levels.

If the acquisition needs to be notified, it may not be implemented before the competition authority (or authorities) has issued its clearance decision. In its review, the competition authority examines the acquisition to see whether it is expected to significantly impede effective competition. This will be the case in particular when the concentration is likely to create or strengthen a dominant position on the market for the acquirer or the target. Such cases are rare; however, where this is found to be the case, the merger will be prohibited and may not be implemented.

When assessing the sale of a start-up, competition authorities will look at whether the acquirer and the start-up are already in competition with one another, whether the start-up is a potential competitor of the acquirer (and possibly just needs time to become competitive) or whether both companies are not competitors (and are unlikely to become competitors in the future). The more intensive the level of competition between the acquirer and the start-up and the more likely it is that the start-up is a growing competitor, the more intense the scrutiny by the competition authorities will be. If the acquirer already has a very strong market position and if the start-up is already or would foreseeably be in the position within the next three years to compete against the acquirer, the concentration may be prohibited. "Buying up" the competition can lead to the strengthening of a dominant market position for the purchaser or – if the start-up is already a competitor – the creation of such a position when the target gives the purchaser the decisive additional market power.

The EU Commission has repeatedly stated that start-ups have a particular competitive value as an innovating factor. Innovation can strengthen a competitor's market position. If a merger would eliminate the start-up as an independent source of competition and innovation on the market, this can curb any incentive for the purchaser and other competitors to innovate. This in turn will reduce the level of competition on the market to the detriment of consumers.

**SUMMARY**

In many cases, the sale of a start-up will not require notification to a competition authority. However, if the start-up has already established itself on the market with a significant turnover or the transaction value is particularly high, the notification requirement might be triggered in Germany and/or in other countries. If notification is necessary, the competitive features of start-ups, in particular their strength in innovation, can lead to greater scrutiny of the acquisition by the competition authorities.

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# Liability Risks for Directors of Start-ups and D&O Insurance Coverage

As a rule, founders will want to avoid being personally liable for the start-up to the extent of their private assets. For this reason, they will generally use a company as the commercial entity, such as a limited liability company. This means that the shareholders are normally not personally liable beyond any capital contribution. In fact, the risks of personal liability for the directors of the start-up, even where a company is used as legal entity, is often forgotten in the euphoria at the initial stages of a start-up. Directors have a duty to the start-up to manage the business of the start-up with the diligence of a prudent businessperson. Directors, who breach their duties, are liable to the start-up for any damage arising (see § 43 German Limited Liability Companies Act, GmbHG).

In their daily work, managers are therefore constantly exposed to a risk of personal liability. Since the *Siemens* scandal, this starts with the recognised obligation on directors to ensure compliance with all relevant laws (compliance). Such statutory requirements are constantly increasing, the General Data Protection Regulation (GDPR) is just one example. In addition, directors have a duty to manage the company with care. Apart from that, the directors have a further, but not unlimited discretionary power when taking decisions on behalf of the company. In addition, the directors must act for the good of the company on the basis of appropriate information. If something goes wrong and the company suffers damage, it has become almost a reflex action today to ask whether the directors can be found liable. Even if frustrated shareholders don't question of the liability of directors for the damage caused, at the latest, an insolvency administrator appointed in the case of insolvency will examine the previous decisions of the directors.

Against this background, it is almost standard now for companies to take out so-called D&O insurance. This provides insurance cover, in accordance with the applicable insurance conditions, when a claim is made against directors for the breach of one of their mandatory duties in their activities for the company. In the case of start-ups, the liability risks for directors are often significantly higher than they are in the case of established companies. Often, reinforced work processes or instructions have not yet been established. The company is likely to face many issues for the first time, so that there are some uncertainties and little experience. Often, personnel or financial resources are not sufficient to allow all relevant issues to be recognised and sufficient care to be taken. Sufficient insurance cover, in particular D&O insurance, is therefore recommended, particularly for start-ups.

This is why we spoke to one of the leading insurance agents about the extent to which these risks can be insured and what you should keep in mind when taking out insurance. As with so many things, the devil is in the details, which in the case of insurance means in particular the scope of the insurance protection and the specific insurance conditions.

**What are the liability risks for managers of start-ups?**

Under law, directors will be liable to the extent of his private assets to the start-up company for all financial loss arising due to a breach of a duty of care. Many start-ups go bankrupt. The most common reasons for this are the lack of business plans, insufficient equity base, no follow-up financing or no "Plan B". A lack of marketing or deficits in accounting or in human resources can also lead to insolvency. Then not only customers, but also official authorities such as tax authorities, data protection authorities, and social security agencies and health insurance funds will proceed against infringements with much more focus than they did a few years ago. At the same time, the claim mentality has changed. In the case of a loss of assets, shareholders and insolvency administrators appointed by the court will not delay for long. They want those responsible to refund any loss suffered by the start-up. The insolvency administrator even has its own liability risk, that he satisfies when preparing the insolvency by assessing whether any claims can be made against board members in order to increase the insolvency assets.

**Can you designate typical board duties?**

Naturally, as a director, I have to comply with all formal rules, i. e. all laws and the articles of association of the company. In addition, I must avoid breaches of my duty of care which may lead to adverse business or risks for the start-up, such as bad investments or debts. Typical duties of directors include selecting the

right personal, properly managing the business operations and continuously monitoring the compliance with all legal, operational and commercial rules. These duties intensify when money is tight. Supervisory or controlling advisory boards also have control duties. Such board members are also liable with their private assets to the start-up if they fail to properly oversee the management and this results in loss of or damage to the assets, or if the board members fail to pursue damages claims against the directors.

**Companies take out D&O management liability insurance on company costs for their directors for exactly these types of cases. Should start-ups do the same?**

Definitely. The risks are the same. Ultimately, managers can be personally liable for bad decisions for minor negligence, and this liability is unlimited. In the case of emergency, the D&O insurance will pay the legal costs of the defence against unjustified claims for damages and will pay out any justified claims. Compensation for damages is also in shareholder's interests, because it guarantees certain "balance sheet protection" for shareholders while later enforcement against private assets may show little chances of success.

**How high are the premiums normally and what documents does an insurer need in order to take out the insurance?**

This depends on the sum that should be ensured insured and its availability on the market and, in particular, on the business plan. Whether, to what extent and for what amount an insurer decides to offer insurance cover depends crucially on their positive assessment. A detailed presentation covering a number of years and including the planned economic developments and financing is important for the insurer's assessment of the risks and the offer of a reasonable insurance quote. The curriculum vitae of the directors and their experience in the field of business also play a role in the assessment of risk. If all factors fit, coverage of EUR 2–3 million can be obtained for premiums of EUR 2,000–4,000. These are normally operating expenses.

**What if the company does not want to finance D&O insurance because the shareholders are against it?**

A director may always take out their own personal D&O insurance and pay for it from their own pocket. The requirements with respect to the necessary documents are the same. A director who takes out his own personal D&O insurance has a sum that is insured and does not need to share this insured sum with anyone else. However, in practice, there is an increased risk that the director will be held personally liable if the existence of this insurance becomes known. For this reason, if possible, the director should not inform the company that he has taken out private D&O insurance.

**What happens when the public prosecutor's office is suddenly standing on the start-up's doormat or the start-up has received post from an investigating authority requesting information about alleged infringements (e.g. data protection infringements, tax evasion, etc.)?**

We recommend taking out company regulatory insurance or company criminal insurance, which the start-up can also pay. When authorities investigate, you cannot control the investigations. The state is not at all concerned about holding the legal person, i.e. the company, responsible, but instead looks to identify the company directors and/or the employees responsible. Those who have to defend themselves against criminal proceedings need a good defence lawyer. And lawyers can be costly. Good criminal insurance will cover even a good lawyer's hourly rate. If the company does not want to pay the insurance premiums, we recommend that directors conclude their own personal criminal insurance at their own costs.

**What should you bear in mind when concluding such an insurance policy?**

The "fine print". The market for director insurance is not consistent and policies can be difficult to understand for directors and even for lawyers. In addition to a good product that provides comprehensive protection for the identified risks, a high degree of expertise in providing advice is fundamental, so that the director will not be left alone "in the rain" in the case of a claim. As a specialist agent, we make our D&O expert teams and our own network of lawyers available, as well as our claims department, which interfaces between customers and the insurer and is there to assist directors in the event of a claim.

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# Beneficial owners – Transparency Register and new rules regarding anti-money laundering checks by notaries

On 1 January 2020, the Act implementing the Directive on the amendment of the Fourth EU Money Laundering Directive entered into force and amended the German Money Laundering Act (*Geldwäschegesetz, GwG*), among others. With this change in mind, we will look at the issue of "beneficial owners" and how they are to be identified and registered. We also look at how and when this issue can play a role for start-ups.

Regardless of the existing notification requirements of the beneficial owner under the Transparency Register (see under 1), the determination and notification of the beneficial owner is particularly relevant for company and real estate procedures and transactions because notaries have a broad obligation to determine the beneficial owner of any parties before them. The changes to the law (*GwG*) even introduce in certain constellations a prohibition against issuing notarial acts or deeds for certain procedures, if the beneficial owner cannot be determined or is not registered in the Transparency Register. In the light of this, companies can expect to be asked more frequently to provide information about their beneficial owners when corporate and real estate procedures are to be notarised (see under 2). In particular prior to financing rounds, founders will have to be prepared to name or respectively determine the beneficial owners of all persons and companies involved, i. e. all current and future shareholders.

## 1. NOTIFICATIONS TO THE TRANSPARENCY REGISTER

Since October 2017, legal persons under private law (i. e. the classical forms of limited liability companies (*GmbH*) and entrepreneurial companies with limited liability (*Unternehmergesellschaft /UG (haftungsbeschränkt*), see below under 1.2), and registered partnerships have been required to electronically register their beneficial owners in the Transparency Register with the body empowered to maintain the register, the *Bundesanzeiger Verlag GmbH*, via the website www.transparenzregister.de. Full name, date of birth, address and nationality of the beneficial owners, as well as the nature and extent of their economic interest must be provided.

Significant fines can be imposed for infringements of these and other obligations under the GwG. The German Federal Office of Administration (*Bundesverwaltungsamt, BVA*) is much more lenient with penalties for late notifications than it is for the failure to register – according to the BVA's catalogue of fines, failure to notify is five times higher than the fines for late notification.

Irrespective of the significant fines, starting January 2020, final and binding fining decisions imposed for infringements of the notification requirement are to be published online in accordance with new § 57 GwG.

The obligation to register this information in the Transparency Register applies initially for domestic companies. Nevertheless, a foreign company must be registered in the German Transparency Register or in the Transparency Register of another EU Member State if it intends to acquire real estate in Germany (see under 2).

### 1.1 BENEFICIAL OWNER

A beneficial owner must be a natural person. Determining their identity is multitiered and should follow the following principles:

- For limited companies or partnerships, the beneficial owners is/are the natural person(s), who directly or indirectly hold(s) 25 per cent of the capital or voting rights or exercise control in a comparable manner.

- If, at this first level, shares are held by companies as well as natural persons, the shareholders of those companies must in turn also be considered (second shareholding tier); the 25 per cent threshold no longer applies to this tier. Here it depends whether control can actually be exercised. This will be the case in particular when a shareholder holds more than 50 per cent of the equity, controls more than 50 per cent of the voting rights or can exercise a controlling influence. This analysis must be carried out for every company until the identity of the natural persons is identified in each case.

- In addition, it must be clarified whether natural persons can significantly influence or prevent decisions of the company in some other way (e. g. control agreements, special rights, blocking minorities, the addition of indirect shareholdings, vote pooling agreements, etc.). Where shares are held by a trustee, the beneficial owner is the trustor.

- If these principles don not allow for any beneficial owner to be identified (e. g. because the five shareholders of a company each hold 20 per cent of the shares), in accordance with § 3 para. 2, fifth sentence GwG, the beneficial owner will be the legal representative, managing director or the partner of the contractual partner. Accordingly, a beneficial owner can always be determined.

These principles show that the question of the beneficial owner can be a complex one and can require closer examination, particularly in the case of multitier shareholding structures or deviations from the control structure of shareholding structures (e. g. trustee, voting pool, or control agreement).

### 1.2 NOTIFICATION REQUIREMENTS FOR GMBHS AND ENTREPRENEURIAL COMPANIES (LIMITED LIABILITY)

The good news is that when GmbHs and limited liability entrepreneurial companies are used for start-ups, which will often be the case, a legal fiction of the notification of the beneficial owner will apply under § 20 para. 2 GwG according to which it is possible to access the list of shareholders (or the model protocol) in the commercial register. Where this is the case, the company will be (automatically) registered in the Transparency Register. The excerpt from the Transparency Register will in any case contain the notice that no information has been provided about the beneficial owners (so-called negative test).

However, the obligation to provide information about the beneficial owners continues to apply, despite an electronically accessible list of shareholders, if the beneficial owners cannot be directly identified from the list of shareholders, e. g. because the shares are held on trust or by legal persons or partnerships, or where the beneficial owners cannot be determined from electronically accessible documents or entries (as will often be the case for companies registered in another country).

For any financing round, in which an investor has acquired more than 25 per cent of the shares in the start-up (or has now reached this threshold as a result of the financing round), one should assess whether the notification obligation has been triggered (see under 1.4). Bear in mind that the shareholdings of a number of i nvestors may need to be added together (e. g. due to voting pools or the fact that one party exercises control over a number of investors).

### 1.3 NOTIFICATION REQUIREMENTS FOR LIMITED COMMERCIAL PARTNERSHIPS (KGS)

The legal fiction of notification under § 20 para. 2 GwG only applies in exceptional cases to so called *Kommanditgesellschaften* (*KGs*). This is because only the amount of liability of the limited partner is registered in the commercial register in accordance with § 171 German Commercial Code (*Handelsgesetzbuch, HGB*), but not their compulsory capital contributions (= share in the capital). The amount of liability and the share in the capital can differ significantly. In addition, without knowing the equity interest of the general partner, which is also not registered in the commercial register, it is impossible to determine the percentage of shareholding held by the general partner.

As the legal fiction of notification does not apply, there will generally be an obligation on KGs to notify their beneficial owners to the Transparency Register.

### 1.4 INVESTIGATION AND DOCUMENTATION REQUIREMENT

If a company has not received any information about its beneficial owners (§ 20 para. 3 GwG), it must request appropriate information on the beneficial owners from its shareholders. Pursuant to § 20 para. 3a new GwG, the company must document the request for information as well as the information it receives. Fines may be imposed for failure to comply.

### 2. MONEY LAUNDERING CHECKS BY NOTARIES – IN PARTICULAR THE IMPACT ON FINANCING ROUNDS

Notaries are always required to formally identify the parties appearing before them (through a valid identity card or passport).

In addition, for all notarizations in the field of corporate law (for GmbHs in particular: the establishment, amendments of articles of association, increases in capital and share sale and transfer agreements; as a result in every financing round) notaries must also identify the beneficial owners.[1] Where the effect of the legal fiction of notification applies (see above 1.2 and 1.3), it will be sufficient for notarial assessment purposes that the evidence of registration in a Register is provided to the notary by the company or that the notary accesses the Register himself (in particular access of the list of shareholders of a GmbH). Additionally, the parties concerned must also confirm that the information contained in the Register provides a complete picture of the beneficial owner(s). This is because there may be arrangements, such as voting pool or trustee agreements, which have the result that the beneficial owner cannot be ascertained from the list of shareholders.

If a start-up has a number of shareholders, the determination of the relevant beneficial owners of each shareholder can be time consuming and complicated, especially where foreign shareholders are involved. This should be taken into account when preparing financing rounds because otherwise the mandatory assessment by the notary and the necessity of answering of corresponding questions for the start-up might lead to delays.

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## Points in time of valuation and receipt for employee participation plans

A start-up's most important asset, other than its founders, are its employees. Start-ups are certainly hip and brilliant minds are deciding more and more in favour of a career in an ambitious start-up rather than for a career path in a large corporate. However, these employees also want to be paid appropriately for their performance. In its early stages, a start-up will not normally have the capital to pay salaries at the going market rate. Accordingly, employee participation programs are often the instrument chosen to provide employees with sufficient incentive and ensure that they play their part in the development of the company.

[1] For completeness – even if it is of little relevance for most start-ups – we note the stricter obligations of notaries with respect to real estate transactions since 1 January 2020: Where companies are involved in transactions that fall within the scope of § 1 German Real Estate Transfer Tax Act (*Grunderwerbsteuergesetz, GrEStG* – particularly contracts for the sale and purchase of real estate and for transactions under company law involving the transfer of real estate in Germany to another legal entity), notaries must make enquiries as to the ownership and control structure of the company(ies) involved. If the parties are unable to present conclusive documentation of the ownership and control structure, a prohibition against the notarization of the contract applies. In addition, where a foreign company acquires real estate, it must be registered in the Transparency Register in Germany or another EU Member State. Evidence of this registration must be provided before the notarial certificate is issued or the notary must have viewed the entry in the Transparency Register himself. Otherwise, the notarization will be prohibited.

Market standard, especially for exit oriented start-ups, is the use of virtual employee participation programs. Each beneficiary receives virtual shares in the company, through which he or she is granted a right to payment of the share of the proceeds equivalent to the share that a "real" shareholder of the start-up would receive when a defined trigger event occurs (normally the exit – whether the sale of the company or its listing on a stock exchange). This puts the employee on equal terms with the founders and, accordingly, provides the incentive for them to work together with the founders towards their common exit.

**For the company**, the major advantage of virtual employee participation programs is that the employees do not have any "real" shareholder rights (e.g. no rights to information or voting rights) and these purely contractual agreements do not change the shareholder structure. Employee participation programs have one major advantage **for employees**, too: tax is only payable for the grant of a virtual share at the date of the transfer, i.e. an actual cash payment is made or shares in the company are transferred to the employee.

A major disadvantage lies in the fact that the calculation of wage resp. income tax and social security contributions is also based on the point in time of the transfer. All increases in value in the period before the transfer are therefore subject to wage resp. income tax (with a personal tax rate of up to 47.5 per cent) and additional social security contributions may also have to be paid. In the case of virtual shares in a start-up, where a rapid increase in the company value can be expected, this can lead to a high burden for personal income taxes and social security contributions, which could make employee participation schemes unattractive. Employees may not know, whether they will have to pay a largest part of the intended incentive to the State.

**EXAMPLE**
The employee is issued 100 virtual shares in the first fiscal year with a market value of EUR 200. The vesting period is three years. By the end of the vesting period, the market value has increased to EUR 1,000.

**RESULT**
The non-cash benefit subject to income tax and social security contributions is EUR 1,000.

Against this background, a number of our clients have inquired about "classic" but more complex employee participation programs for granting employees from the beginning "real" shares in the start-up directly or indirectly through a company founded for this specific purpose. As the point in time when the shares were transferred is decisive for the assessment of the non-cash benefit, the personal income tax and social security contributions will accordingly be lower. The subsequent increase in the value of the start-up until the sale of the shares by the employees is then only subject to a withholding tax of 26.375 per cent.

**RESULT IN THE EXAMPLE**
The non-cash benefit relevant for wage resp. income tax and social security contributions amounts to EUR 100.

One disadvantage in this case could be that the obligation to pay wage resp. income tax and social security contributions already arises at the point in time when the shares are transferred. Wage tax and social security contributions needs to be withheld by the employer or the employer needs to request the required amounts from the employee. If the employee has to observe a vesting period for the shares, this would mean that he or she has to pay tax before they can turn the shares into cash. In this instance, therefore, the shares are unlikely to provide much incentive for the employee.

The art, therefore, is to draft these "classic" employee participation programs in a way that the earliest possible point in time (e.g. when the employee joins the employee participation program) is used for the assessment of the non-cash benefit, while the latest possible point in time (e.g. the end of the vesting period) applies for the withholding of wage tax and social security contributions.

In an individual case, this could be done by transferring the shares in the company to the employee in principle upon joining the employee participation program in exchange for a cheapened price, while still ensuring that the employee cannot dispose of or otherwise profit from the shares during the vesting period.

**RESULT IN THE EXAMPLE**
The non-cash benefit applicable to the calculation of wage resp. income tax and social security contributions amounts to EUR 100. However, the wage tax and social security contributions are only payable after the end of the vesting period, so that the employee can finance the payment of these taxes from the sale of the shares at the end of the vesting period (if required).

We successfully advised on such a program at the start of this year. If you therefore have any questions about this topic, please feel free to contact us.

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# "So test, therefore, who join forever!" – Trial periods in an employment relationship

Employees, in particular start-ups who have little money or time to waste, should make good use of probationary periods in employment relationships. Trials serve as a time to test something before the position is solidified. You test wine at a restaurant before drinking it, go for a test-drive in a car before buying it, you don't get married at first sight, and thus a new employee should be put to the test in a trial period, too. The regulation of a "trial period" in an employment relationship is quite different from how such trials are commonly understood.

### THE PROBATIONARY PERIOD AS A SHORTER NOTICE PERIOD

The trial period – as German law understands – is set out in § 622 para. 3 of the German Civil Code (*Bürgerliches Gesetzbuch, BGB*):

"*During an agreed probationary period, at most for the duration of six months, the employment relationship may be terminated with a notice period of two weeks.*"

In an employment agreement, a "probationary period" within the meaning of § 622 para. 3 BGB merely regulates the notice period during that probationary period. By agreeing to a trial period, a notice period of two weeks applies for the duration of that trial period. Rules – which are otherwise common – requiring the notice period to end on a specific termination date (e.g. end of the month, quarter or year) do not apply. You do not need to specifically agree on this brief notice period. However, you may agree on a longer notice period for this trial period. The "probationary period", as established by German law, merely means that the short two-week notice period applies for the first six months of the employment relationship at the most. For start-ups, a short notice period and the ability to terminate at any time makes sense because employees, who don't work well in the team or don't perform do not need to be unnecessarily "carried" and paid for a long time.

### THE TRIAL PERIOD AS A WAITING PERIOD

The trial period – as it is commonly understood – is regulated in § 1 para. 1 of the German Protection of Employment Act (*Kündigungsschutzgesetz, KSchG*):

"*The termination of an employment relationship of an employee who has been employed in the same establishment or the same company without interruption for more than six months is legally invalid if it is socially unjustified.*"

During the first six months of an employment relationship, the termination of that relationship will be justified – without the need for an explicit rule in the employment agreement – without grounds for dismissal within the meaning of the German Protection of Employment Act. Any notice of termination issued during the first six months of the employment relationship may not be vexatious, arbitrary or discriminatory. Pursuant to § 1 para. 1 of the German Protection of Employment Act, the issuance of a notice of termination will be permissible during the waiting period if the employee simply "does not fit".

### WAVING THE TRIAL PERIOD MEANS WAIVING THE SHORTER NOTICE PERIOD

If a start-up has an employment agreement which contains a clause, such as "no trial period is agreed", it does not mean that the parties have agreed to waive the six month waiting period to postpone the general protection against unfair dismissal under § 1 para. 1 of the German Protection of Employment Act. It merely clarifies that no trial period within the meaning of § 622 para. 3 BGB has been agreed and, therefore, that the shorter notice period does not apply. The termination of the employment relationship within the first six months without grounds for dismissal is therefore still permissible (see judgment of the German State Labour Court (*Landesarbeitsgericht, LAG*) of Baden-Württemberg of 18 June 2019 in Case No. 15 Sa 4/19).

**TIP**

A notice of termination may still be issued on the last day of the "probationary period".

There is a rumour that any notice of termination issued during a trial period will only be permissible when the notice period ends within that trial period. An example: an employment relationship starts on 1 January 2020 so that the waiting period expires on 30 June 2020. If this rumour is right, the notice of termination would have to be issued to the employee with at least the two-week notice period left before the end of the trial period, i.e. it would need to be issued by 16 June 2020 at the latest. This rumour is incorrect. It is sufficient for the notice of termination to be delivered to the employee on the last day of the "trial period". In the example, therefore, a notice of termination issued on 30 June 2020 would mean that the employment relationship ends on 14 July 2020.

### EXTENDING THE TRIAL PERIOD

Start-ups often also ask whether a trial period can be extended. This question does not mean that the parties agree to extend the duration of the period in which shorter notice periods apply in accordance with § 622 para. 3 BGB, but that the German Protection of Employment Act should not apply for a period longer than six months.

If the employer realises that the cooperation with the employee is not working or that the employee does not fulfil the requirements, is not sympathetic or does not work well in the team, their employment should be terminated "during the trial period". This is particularly true for smaller entities, such as start-ups. Six months is actually quite a long time to "test" an employee. In our experience, an employee that has not demonstrated the suitability within six months is unlikely to prove the worth after the six months either. Still, we have employers and start-ups asking again and again whether a trial period can be extended. An extension of the trial period either in terms of an extension of the waiting period before § 1 para. 1 of the German Protection of Employment Act applies or

in terms of the extension of the period in which a shorter notice period may apply in accordance with § 622 para. 3 BGB, is inadmissible. Nevertheless, the courts have recognised a possible "extension of the trial period" as being permissible.

## FIXED-TERM EMPLOYMENT AGREEMENTS WITH AND WITHOUT OBJECTIVE GROUNDS

If, shortly before the expiry of the six month trial period, the employer is not sure whether he wants to continue working with the employee or not, the employment relationship and the trial period may be extended by a fixed-term agreement without objective grounds for that fixed term within the meaning of § 14 para. 2 of the German Part-time and Limited-term Employment Act (*Teilzeit- und Befristungsgesetz, TzBfG*). A fixed-term employment agreement without an objective reason for the fixed term requires there to have been no prior temporary or permanent employment relationship with the same employee. This requirement would not be fulfilled where there was a previous trial period as an employment relationship existed during that trial period.

Conversely, an agreement may always have a fixed term when there is an objective reason for that fixed term. In practice, it is often difficult to find an objective reason within the meaning of § 14 para. 1 of the German Part-time and Limited-term Employment Act for an "extension" of the trial period (e.g. cover for another employee, a fixed term based on a court-approved settlement).

## POSSIBLE SOLUTIONS

Shorter notice periods generally apply during the trial period. As a result, the case law permits a "trial period extension" where the employment relationship may be terminated or ended by concluding a termination agreement during the trial period with a longer, appropriate notice period rather than the shorter notice period, in order to allow the employee to be tested for a longer period. This *de facto* extension of the trial period "outsmarts" the German Protection of Employment Act. The issue of the notice of termination or conclusion of the termination agreement occurs during the trial period as at the point of time the German Protection of Employment Act does not yet apply. The Act will, however, apply when the employment relationship ends. For the extension of the trial period to be permissible, the following requirements must be met:

- there may not be a significant extension of the normal short notice period of two weeks during the trial period, a three to four-month notice period is an appropriate duration;
- the employee must be informed that they have failed to prove themselves during the trial period and that they now have a further chance to prove themselves;
- the "trial period extension" may not only be or may not primarily be in the interests of the employer (e.g. to bridge personnel shortages);
- the employee must have the chance to be reinstated (reinstatement guarantee); and
- in the case of a termination agreement, typical elements such as a release from duties, a written reference, severance or the return of company property must be regulated.

In light of these criteria, an employer, who considers that the employee has failed to pass the trial period, may, instead of terminating the employment relationship with a short notice period normally of two weeks, give the employee an additional chance to prove themselves. In accordance with the case law of the German Federal Labour Court (*Bundesarbeitsgericht, BAG*), the employer must provide a clear and longer notice period or conclude a termination agreement and guarantee that the employee will be reinstated should they prove themselves.

## TERMINATION INSTRUMENT: NOTICE OF TERMINATION, TERMINATION AGREEMENT OR WINDING-UP AGREEMENT

An unilateral notice of termination issued by the employer, a termination agreement or a winding-up agreement (*Abwicklungsvertrag*) may be used to terminate the employment relationship during the trial period with a longer notice period in which to test the employee. Compliance with all formalities must be ensured, for example, the issue of a notice of termination requires written form and the possible previous hearing of the works council.

## MAXIMUM EXTENSION OF THE TRIAL PERIOD

The German case law is not entirely clear on for how long a trial period may be extended. There should be an appropriate relationship between the notice period under the agreement, statute or collective agreement during the trial period, which is often only two weeks, and the extension. There is agreement that the longest possible relevant notice period should not be exceeded in any case. According to § 622 BGB, the longest possible notice period is seven months. In various judgments, the German state labour courts have held that it is permissible to extend a trial period by a notice period of three or four months.

## INFORMATION FOR EMPLOYEES

In order to prevent that a fixed-term employment agreement without a justifiable reason for the fixed term is found to be unlawful, the employee must be informed that he failed to prove himself during the trial period and that the employer is giving the employee another chance to prove himself until the end of the employment relationship. In addition, the employer must promise the employee that he will be reinstated if he uses this second chance and proves himself before the end of the notice period. It is imperative that the notice of termination, termination agreement or winding-up agreement contain the keywords "further chance to prove yourself" and "the prospect of reinstatement".

The notice of termination, termination agreement or winding-up agreement may not mention that the longer trial period is for operational reasons because this would document that the extension is only or is primarily in the interests of the employer, e.g. due to staff shortages.

"Everything must come to an end…" even the employment relationship. In many cases, it is advisable to use a trial period to conclusively terminate the employment relationship. Start-ups will

save a lot of time, money and hassle. If a trial period is to be extended, it is vital that all criteria are met and, in particular, that the extension is not for more than three or a maximum of four months.

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# The question of health insurance for start-ups

*Interview with Frank Mayer. Frank Mayer is the Regional Managing Partner for BARMER in Frankfurt am Main and has been advising businessmen and businesswomen in the Rhine-Main Region since 2015.*

**Mr Mayer, young entrepreneurs, and those who want to become entrepreneurs are often faced with questions about what makes for good health insurance when you are self-employed. Of course, there are alternatives to voluntary continued insurance under the statutory health insurance system (SHIS). Private health insurers look appealing during the first few economically challenging years of the start-up. What do self-employed people need to know in order to make a prudent choice at this stage?**

Above all, they should consider long-term development in their decision. For years, the premiums for private health insurance (PHI) were relatively stable, so that there was quite a long time period in which you could save money if you had PHI rather than statutory health insurance. Often, you only had to pay more for PHI when you were 50 to 60 years old, and the average age expectancy was significantly lower. The calculation was correct in most cases. However, the difference in premiums compared to SHI now disappears much earlier, for most people when they turn 40. The period in which PHI premiums are higher than SHI premiums is – with higher life-expectancy – much longer. Ten years of savings now often means 40 years paying more for PHI. According to a study by "Finanztest", you should anticipate having to pay at least three times the initial premiums for PHI when you reach 40.

**Aside from these economic considerations, how do the ranges of services compare? Are statutory health insurers competitive in this respect?**

Apart from the statutorily prescribed scope of services, all health insurers – the statutory ones too – negotiate their specific scope of services through supply agreements. For those with SHI, a broad spectrum of additional insurance, such as for additional dental care, is also available. The assumption that you will always get better care with PHI because of the higher premiums is no longer tenable. For BARMER, for example, health checks and preventative measures, remedies and therapeutic aids, high quality standards and seamless medical care, as well as the protection of the family are very important. Self-employed entrepreneurs must therefore ask themselves "What will my life look like in the future? What care will I need? What will these decisions mean for my partner or children?"

**What role should family planning play in the choice of health insurers?**

The choice between private and statutory health insurance is a choice of system, which will have wide-ranging consequences for the future. If you fail to plan here, you might make decisions that have an impact on your spouse or children down the line. In contrast to statutory health insurers, private health insurers do not offer free family insurance; instead, a premium must be paid for each child. There are no maternity benefits and often no sickness benefits in the case of an ill child. PHI does not take into account changes to your professional life, such as part-time positions or parental leave, while SHI is based on current income. In fact, you can only go back to SHI when your salary sinks below the so-called annual wage limit (Jahresarbeitsentgeltsgrenze). In 2020, this limit is EUR 5,212.50. When you reach 55, there is no going back, even in the case of unemployment.

**Which system adapts better to complex and changing lifestyles?**

Young people in particular need flexible health insurance that adapts to suit their position in life, their goals and their aspirations. For this reason, legislators recently strengthened the rights of the insured: in the future, it will be easier to change to a different health fund, increasing competition between SHIs. In contrast, taking out PHI is more like signing a contract to bind yourself to the same mobile phone tariff for your whole life. BARMER aspires to react to transitioning modern lifestyles and to continue to offer leading health care concepts for people with the initiative and courage to start their own company. That's why the Family-Plus Bundle from BARMER is particularly designed for the everyday, working and family lives of parents and children – who knows, perhaps starting a family will follow starting a company.

**Frank Mayer**
Regional Managing Partner for BARMER
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