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Ruling of the German Federal Labor Court on the Invalidity of Expiry Clauses in ESOP/VSOP – Applicability of the Ruling to MEPs

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A. Overview

1. The Ruling of the German Federal Labor Court

On March 19, 2025, the German Federal Labor Court (BAG) ruled that clauses that qualify as general terms and conditions and stipulate that virtual option rights that are already vested at the time of termination of an employment agreement shall expire with immediate effect (Expiration Clauses) are inappropriately disadvantageous for the beneficiary and therefore invalid (Ruling). Even if such Expiration Clauses do not provide for immediate expiration but rather provide for the option rights to expire twice as fast as the option rights took to vest within the vesting period, they are inappropriately disadvantageous and therefore invalid as well. The BAG is thus expressly abandoning its differing prior rulings, which were reaffirmed in 2008.

In the case in question, the claimant (an employee of the defendant and beneficiary of the partially vested option rights) had terminated its employment agreement with the defendant (employer) after two and a half years of service. The claimant participated in the defendant's employee stock option program, which provided for a total vesting period of four years (including a one-year cliff). According to the Ruling, the employee had earned his vested virtual option rights at the time of termination and — due to the invalidity of the Expiration Clause — these vested option rights have not expired retroactively due to the termination of the employment relationship.

So far, only a press release has been published on the Ruling — the detailed reasons for it have not yet been published. Such detailed reasons will provide further clarity and may lead to a new assessment from the one set out herein.

2. Significance of the Ruling for Private Equity Transactions

In the context of management equity or management incentive programs (together, MEP), which are common in PE transactions and in connection with which the participants acquire shares in an MEP vehicle (MEP Entity) from an affiliated warehouse entity, the Ruling raises the question as to whether the other German federal courts are likely to follow the Ruling and thereby render similar clauses in the MEP documentation invalid as well. Particularly, clauses in the MEP documentation providing for a call option or comparable arrangements for the repurchase of the MEP shares in favor of the MEP Entity/warehouse entity in the event of a so-called bad leaver event (Bad Leaver Clause) could be in jeopardy.

B. Executive Summary

1. The Ruling constitutes a break with previous case law. The effects of the Ruling and whether BAG will come to the same conclusions in future cases will need to be closely monitored, particularly in constellations in which an employee is the beneficiary of vesting MEP shares in a MEP Entity that is not identical with the entity that employs the employee (Employer Entity).

The decision may also have an impact on the future rulings of the German Federal Court of Justice (BGH) regarding the validity of Bad Leaver Clauses in cases in which the beneficiary in question is a managing director or member of a corporate body of the Employer Entity.

2. Based on the reasons set out in section C, in our opinion, it is rather unlikely and therefore currently only a purely theoretical risk that the courts (whether the BAG or BGH with regard to employees or managing directors/board members, respectively) might come to a conclusion similar to the Ruling with regard to Bad Leaver Clauses.
3. The Ruling is also of particular relevance regarding Expiration Clauses/Bad Leaver Clauses in ESOP and VSOP schemes as well as in exit bonus agreements. These issues are outside the scope of this article.
4. Subject to the publication of the detailed reasons of the Ruling and pending future rulings by the federal courts, to minimize the risk in connection with Bad Leaver Clauses in the MEP documentation, the measures set out in section D should be considered and complied with.

C. Applicability of the Ruling to MEP Participations

In our opinion, future concurrent rulings by the BAG or BGH concerning Bad Leaver Clauses — with regard to typical MEP structures in connection with PE investments — seem rather unlikely, hence, Bad Leaver Clauses are not anticipated to be deemed invalid by the German courts. This assessment is based on the following considerations:

1. Applicability of the Ruling to Non-Employees

Usually, only managing directors and other board members of the portfolio companies participate in the MEP and, hence, are the predominant group of participants (based on their portion in the total equity). These persons are not qualifying as employees under German labor law. In contrast to the Ruling, in which the claimant was an employee, German labor courts are not the competent courts for any litigation pertaining to a managing director's or board member's service. Therefore, on the federal court level, the BAG will not be ruling on such matters. Additionally, the review of the validity of Expiration Clauses/Bad Leaver Clauses in connection with a managing director's or board member's participation is subject to far less stringent requirements than those in connection with an employee's participation in such schemes.

2. Non-identity of Employer Entity and MEP Entity in MEP

- 2.1. In contrast to the Ruling, in which the claimant was employed by the same entity in relation to which the option rights were granted to the claimant, in default MEP structures in connection with private equity investments, the Employer Entity is generally not identical with the MEP Entity.

- 2.2. The MEP Entity is in fact set up as a separate entity specifically for MEP purposes. Consequently, no employment relationship exists between the participants of the MEP (regardless of whether such participants are managing directors/board members or employees) and the MEP Entity, but rather a purely corporate relationship. The BAG is not the competent federal court regarding any legal disputes in connection with the MEP, and therefore, the risk of the relevant court coming to the conclusion that the potential financial incentives in connection with the MEP qualify as "remuneration" seems very low, as the labor/service is performed for the benefit of another entity, namely the Employer Entity, and

not the MEP Entity. Further, the achievement of the financial incentivization under the MEP is regularly based on the performance of a group of companies (comprising the Employer Entity) and not just of the Employer Entity.

3. MEP Participation Does Not Qualify as Mere Remuneration

- 3.1. In connection with a MEP, the parties provide for a monetary investment of the participant as consideration for the purchase of shares in the MEP Entity which investment, essentially, in the event of a successful exit, shall entitle the participant to a certain portion of the exit proceeds if all conditions to such entitlement are met. The occurrence of a successful exit depends not only (or even primarily) on the performance of the participant but largely on circumstances beyond its control. Any financial benefits from a MEP participation should therefore not be considered part of the participant's remuneration or as "earned" through the performance of the participant's work/services, but rather a result of its investment in the MEP.
- 3.2. This is supported not only by (i) the motives from the perspective of the private equity sponsor — among other things, synchronization of the investor's and management's interests to achieve the highest possible exit proceeds and confirmation of "commitment" of the management to the joint undertaking (skin in the game) — but also (ii) the tax-driven interest of the participants that the proceeds in connection with the MEP participation are not classified as part of the participant's wage for the work/services rendered by the participant. The argument under (ii) does not apply to a VSOP participation due to the different tax treatment of such schemes.
- 3.3. It would therefore be contradictory if, on the one hand, the participant argued that its MEP participation is to be qualified as an investment to avoid certain tax disadvantages that would result from a qualification as employment-related remuneration, but on the other hand, in the event of a bad leaver event, would assert that its MEP participation is part of its remuneration.
- 3.4. In conclusion, the main factor regarding an MEP is the achievement of a successful exit, the proceeds of which primarily benefit the investors, and not the purpose of incentivizing the management or participating employees for their work/services additionally to their regular wage.

4. Less Severe Consequences of a Bad Leaver Event

- 4.1. The usual consequences of a bad leaver event that are provided for in the MEP documentation are also less severe than in the case underlying the Ruling. Although the right to repurchase the participant's shares in the MEP Entity after the occurrence of a bad leaver event has detrimental financial consequences for the participant, since — compared to a good leaver event or a sale for exit — the MEP shares are repurchased at a significantly lower repurchase price, this is not per se to be qualified as economically equivalent to a total loss of the option rights (as was the case in the case considered in the Ruling). Rather, it depends on the specific circumstances, namely, the amount of repurchase price to which the participant is entitled pursuant to the Bad Leaver Clause under the MEP documentation.
- 4.2. In previous rulings, the BGH ruled that provisions that, in the case of repurchase of a participant's shares in the MEP Entity after a bad leaver event, only provided for the book value of the MEP shares or a market value potentially lower than the book value as repurchase price, could be invalid based on the specific circumstances.

D. Necessary Considerations Regarding the MEP Structuring and MEP Documentation

To reduce the risk of a potential invalidity of Bad Leaver Clauses, to the extent feasible, any impression of a connection between the employment relationship and the MEP participation as well as the applicability of mandatory German statutory law should be avoided by ensuring, among other things, the following:

1. Structuring of the MEP

- 1.1. The MEP Entity should neither be the Employer Entity nor a direct shareholder of the Employer Entity;
- 1.2. The negotiation of the MEP documentation and any related communication with the participants should always be conducted via the MEP Entity/deal team and not via the Employer Entity or its management;
- 1.3. The participants should ideally render legal advice in connection with their participation (and this should be expressly suggested to the participants and documented) in order to mitigate the impression of imbalance/a one-sided setting of the MEP terms and the impression that the documentation can only be accepted as provided should be avoided; and
- 1.4. Ideally, the MEP Entity should be a company of a foreign jurisdiction and the MEP documentation should be governed by the laws of a jurisdiction other than Germany to mitigate the likelihood of applicability of German law — with the caveat, that certain requirements under German statutory law regarding the validity of general terms and conditions are mandatory and generally cannot be circumvented.

2. Documentation

- 2.1. The employment agreement and the MEP documentation (including any term sheets agreed in advance) should be kept strictly separate and not included in the same agreements.
- 2.2. The employment and service agreements of the MEP participants should not include any reference to the (existing or potential) MEP. However, necessary references to the employment relationship in the context of, inter alia, the leaver provisions in the MEP documentation seem to not be detrimental and may be included.
- 2.3. The MEP documentation should provide for the conclusion of an arbitration agreement that stipulates that disputes in connection with the MEP are not subject to litigation, but rather arbitration. This ensures that the arbitration courts, which are usually more experienced in commercial matters, and not the ordinary or labor courts, rule on the legal dispute.
- 2.4. Insofar as the MEP documentation stipulates that, in the event of a bad leaver event, the MEP shares can be repurchased at book value or at a market value potentially lower than the acquisition costs, this may represent a potential gateway for the courts to rule such provision invalid. Past case law of the BGH shows that it cannot be ruled out that such a clause will be qualified as unreasonably disadvantageous and therefore invalid. To minimize this risk, it seems opportune (subject to the specific circumstances) to grant a certain additional minimum interest rate and thus a repurchase price above the book value, even in the case of a bad leaver event.

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