Morgan Lewis

1ST EDITION

MANAGEMENT EQUITY VADEMECUM

GERMANY

This Vademecum is as of January 2018 and provides initial guidance on certain key terms as they are typically used in management equity schemes. Nothing in this Vademecum shall constitute or shall be construed or understood as legal advice.

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Accession to MEP

Managers typically invest via a management vehicle into a joint holding company of the portfolio company alongside the PE investor. When acceding to the MEP, managers have to fund the participation amount for the participation at fair market value (at the same valuation as the PE investor). Managers technically become shareholders (partners) of the management vehicle. The instruments acquired by the management vehicle will be allocated to the managers on the basis of the participation amount funded by the managers.

Additional Funding

The PE investor is typically granted the right to implement additional equity funding at any time, for example in order to finance add-on acquisitions or provide emergency funding in a distressed situation. The PE investor has the right to decide upon the structure of the equity funding (share capital increases, shareholder loans, hybrid instruments) at its sole discretion. Management is often granted the right to participate via the management vehicle in the additional funding proportionate to its shareholding and on a pari passu basis with the PE investor.

Bad Leaver

Typically, a manager who terminates his/her employment or service agreement with the portfolio company without cause or who is terminated for cause by the portfolio company qualifies as a bad leaver. Violation of the partnership agreement may also lead to a qualification as a bad leaver. The definition of a “bad leaver” is agreed in the partnership agreement.

Call-option (in case of Leaver Event)

The PE investor is often granted a call-option right to acquire the participation of a leaver in the management vehicle. In some schemes, the call-option only applies to a non-vested management participation. In other schemes, the call-option is not available for the PE investor in relation to the institutional strip investment. The consideration to be paid to the leaver typically depends upon whether he/she qualifies as a good leaver or bad leaver.

Capital Gains Taxation

If the shareholding of an individual in a corporation was below 1% at any time during the last five years prior to the disposal, a flat income tax rate of 25 % plus solidarity surcharge of 5.5 % thereon applies (plus church tax, if applicable). In case the shareholding equaled or exceeded 1% at any time during the last five years prior to the disposal, 40 % of the sale proceeds are tax exempt whereas the remainder of 60 % is taxed at the shareholder's (manager's) individual income tax rate plus solidarity surchcharge (plus church tax, if applicable). The same distinction is made in case of a disposal of partnership interests in the non-deemed trade management vehicle to the extent sale proceeds are attributable to the (indirect) disposal of shares in the joint holding company or the portfolio company held by the management vehicle.

Catch-up Right

In specific additional funding situations, such as add-on acquisitions, the PE investor will insist on having the right to pre-fund new cash. Management may request a catch-up right to re-balance the dilution triggered by the pre-funding of the PE investor.

Corporate Governance

The corporate governance of the management vehicle and the joint holding vehicle is driven by the overall economic participation in the portfolio company. The PE investor as the majority shareholder ensures via the shareholders' agreement and the partnership agreement that "it has the say" in the control of the investment structure. The PE investor typically also controls the management vehicle via the general partner. The investment by the managers is a financial investment, not a "control" investment.

Dilution Protection

In additional funding situations, management is typically protected by pro-rata participation rights in the additional funding round and the principle that any issuance of new instruments shall occur at fair market value.

Drag-along Right

Right of PE investor to force management vehicle to co-sale its instruments in the joint holding company in the event of an exit on same terms as PE investor.

Employment Relationship

The participation in the MEP is not part of the employment relationship of the manager, but is a separate investment relationship the manager enters into on the basis of corporate law. The benefits a manager may enjoy in connection with the MEP are not part of the salary package, if the manager acquires his participation in the management vehicle at fair market value.

Exit

Exit of PE investor from its investment in the portfolio company. Exit typically takes the form of (i) a sale of majority of shares by PE investor in the portfolio company to a third party, (ii) the sale of all substantial assets of the portfolio company to third party or (iii) an IPO. The shareholders' agreement typically defines which transactions qualify as an exit.

Exit Strategy

The PE investor determines the strategy, structure and timing of the exit. Blocking or veto rights of management in relation to an exit are excluded. The managers undertake to cooperate and support and PE investor in the event of an exit, including the preparation of due diligence materials, information memoranda, disclosure schedules, prospectus or similar documents, the participation in Q&A sessions and the support of any restructuring measures prior to, or in connection with, an exit.

Fair Market Value

Valuation of the management participation at fair market value in particular becomes relevant when exercising the call-option in the context of a leaver event or in case of additional funding. Often, the fair market value is determined on the basis of the PE investor's latest fund valuation.

Good Leaver

A manager whose employment or service agreement with the portfolio company terminates without such termination being imputable to the manager, for example in case of a termination of the employment or service agreement by the portfolio company without cause. In some schemes, circumstances or events qualifying a manager as a good leaver are listed in a specific catalogue while in other schemes all leavers which do not qualify as a bad leaver qualify as a good leaver.

Hurdle

Some schemes provide for an economic hurdle to be achieved in an exit in order to trigger economic entitlements for the managers under the management instruments.

Income Tax

Tax on the income of individuals, in particular on income from (German source) employment. An individual tax rate applies on which additional solidarity surcharge of 5.5% applies (plus church tax at a rate of 8-9%, if applicable). Income tax is levied on remuneration in cash and/or in kind which an employee actually receives. Expenses related to the employment can be deducted. The employer is obliged to deduct income tax ("wage tax") at source.

Institutional Strip

Investment of managers via the management vehicle along-side the PE investor at pari passu terms.

Instruments

The equity or debt instruments issued by the joint holding company to the management vehicle and the PE investor are often referred to as instruments. These instruments can be ordinary shares, preference shares (with or without interests), shareholder loans or shareholder loan-like instruments.

Investment Risk

The manager bears the economic risk of his/her investment into the MEP. The participation in the MEP provides chances for value creation, but at the same time bears risks associated with the investment. By participating in the MEP, the manager will profit from any increase in value of the portfolio company; however, adverse developments could lead to a loss in value of the investment or, in the worst case, a loss of the investment by the manager in its entirety.

IPO

Initial public offering of shares of the portfolio company. In order to market the IPO, lock-up obligations of management play a key role. Managers are typically expected to undertake to enter into lock-up obligations.

Joint Holding Company
Company in which the PE investor and the management vehicle hold instruments. The joint holding company is typically a direct or indirect holding company of the portfolio company. In some structures, the joint holding company is the portfolio company.

Leaver
Manager whose employment or service agreement with the portfolio company terminates.

Leaver Consideration
In case the PE investor exercises the call-option to acquire the management participation of the leaver, the leaver is entitled to a consideration for the management participation. The leaver consideration depends on whether the leaver qualifies as a good leaver or a bad leaver. The good leaver is typically entitled to the fair market value of his/her management participation at the time of the occurrence of the leaver event. The bad leaver is often entitled to the lower of (i) his/her participation amount or (ii) the fair market value of the management participation at the time of the exercise of the call-option or the occurence of the leaver event.

Leaver Event
Event leading to the termination of the employment or service agreement between the manager and the portfolio company.

Management Equity Strip (“Sweet Strip”)
Disproportionate allocation of equity instruments to management when compared to PE investor. Such a situation arises,

for example, when the PE investor, on a pro rata basis, holds more shareholder loans than the management vehicle, and the management vehicle, as a consequence, on a pro rata basis holds more equity instruments. Such disproportionate equity allocation benefits the managers in case of a successful exit because the shareholder loans are "capped" at the loan repayment amount including interest. In an unsuccessful exit, however, the shareholder loans benefit as a consequence of their higher rank when compared to pure equity instruments.

Management Instruments
Instruments held by the management vehicle in the joint holding company.

Management Participation
Participation of the individual manager in the management vehicle. The management instruments held by the management vehicle in the joint holding company are allocated to the managers on the basis of the management participation of each manager at the level of the management vehicle.

Management Vehicle
Managers typically invest indirectly through a pooling vehicle in the management participation scheme. That management vehicle, often in the legal form of a GmbH & Co. KG (German limited partnership with a GmbH as the general partner), is used as a joint investment vehicle for all managers to facilitate the administration and corporate governance of the structure. For tax reasons, in particular with respect to capital gains, usually a so-called "non-deemed trade limited partnership" structure (*"nicht gewerblich gepraegte GmbH & Co. KG"*) is employed in which some limited partners are appointed managing partners. Trustee structures

where a trustee holds management instruments in trust for the managers are sometimes used, but are currently not the norm in the German market.

Management Warranties
Warranties given by management in connection with the acquisition of the portfolio company by the PE investor. Managers are in some instances asked to give management warranties in connection with their investment in the MEP.

Managing Partner(s)
Managing partners of the management vehicle are typically the general partner as well as one or two limited partners. The managing partners conduct the management of the management vehicle. The general partner of the management vehicle is typically controlled by the PE investor while at least one managing limited partner is typically a manager invested in the MEP.

MEP
MEP means management equity participation program. The purpose of the MEP is to incentivize selected key managers employed with the portfolio company with regard to the financial performance and to align the interests with the PE investor to achieve a successful exit.

Non-Compete
Non-compete obligations result from the employment or service agreement of the manager, and in some instances also from the partnership agreement of the management vehicle.

Ordinary Shares
Ordinary (voting) shares issued by the joint holding company.

Participation Amount
Amount (to be) paid by the manager to acquire his/her management participation.

Partnership Agreement
Constitutional document of the management vehicle (in the form of a partnership) through which the managers invest in the joint holding company, and thereby indirectly in the portfolio company. The partnership agreement in particular regulates the corporate governance of the management vehicle, the allocation of the instruments held by the management vehicle in the joint holding company, as well as the basis terms of the corporate governance within the management vehicle. In addition, the partnership agreement typically contains provisions on leavers.

PE Investor
Investment vehicle controlled by the PE funds investing into the portfolio company.

Permitted Restructurings
The shareholders' agreement typically provides for the right of the PE investor to implement certain restructurings, in particular with a view to prepare for an exit. Permitted restructurings are in particular important in an IPO scenario where often the legal form as well as the instruments issued by the portfolio company or the joint holding company are changed prior to an exit.

Portfolio Company
Operative target company the PE investor invests in (jointly with the management vehicle via the joint holding company).

Preference Shares
Preference shares issued by the joint holding company. They may carry a yield/interest coupon, are typically non-voting shares and may be designed to be convertible into ordinary shares upon the occurrence of certain events.

Ranking
The instruments issued by the joint holding company have a certain rank according to which the proceeds (resulting from an exit) must be distributed. The ranking of the instruments is known as the so-called proceeds "waterfall".

Re-investment (in Secondary Buy-out)
In case of a "secondary" buy-out by a PE investor, the incumbent management is often already invested in a management participation scheme. The new PE investor typically expects management to re-invest at least part of the proceeds from the former management participation scheme into the new MEP.

Reserved Instruments
A certain percentage of instruments is often reserved for future managers joining the scheme. Such reserved instruments are typically held by a warehouse entity, which is controlled by the PE investor.

Scheme
The term "scheme" is also used for management equity participation program or MEP.

Shareholder Loans
Loans granted by the PE investor and/or management vehicle to the joint holding company. Shareholder loans typically carry an

interest and are used as an instrument to design the overall structure of the investment, including the waterfall in case of an exit.

Shareholders' Agreement

Agreement between the PE investor, the management vehicle and the joint holding company which primarily regulates the relationship between the PE investor and the management vehicle. The shareholders' agreement typically contains provisions in relation to additional funding, corporate governance of the joint holding company and the portfolio company and an exit. The waterfall is typically also described in the shareholders' agreement.

Tag-along Right

Right of management vehicle to co-sale management instruments in case of an exit alongside the PE investor on a pro rata basis on same terms as PE investor.

Taxes

Each manager is responsible for his/her personal tax effects of the participation in the MEP. Subject to the structure of the MEP and the residency of the manager, gains resulting from the MEP may be subject to capital gains tax rather than income tax.

Transfer Restrictions

The management vehicle is not entitled to dispose of the instruments held in the joint holding company without the consent of the PE investor. In the event of an exit which takes place in the form of a private M&A deal, the management vehicle might be entitled to a tag-along right. On the level of the management vehicle, managers are not allowed to transfer their participation to third parties. In some schemes, a manager has the right to transfer his/her management participation to a company controlled by it.

Vesting

In some schemes, the management participation "vests" over time, *i.e.* cannot be acquired by the PE investor from a (good) leaver by exercising the call-option.

Virtual Shares

Some management participation programs are designed in a way that managers do not invest in instruments issued by the joint holding company, but receive "virtual shares" that are allocated to them. Under a "virtual share plan", managers are treated as if they were holding equity instruments in the share capital of the joint holding company. Typically, managers do not pay a purchase price for virtual shares. The terms of the virtual shares are typically regulated in an agreement between the joint holding company and the manager.

Warehouse

A vehicle controlled by the PE investor holds a participation in the management vehicle and operates as a "warehouse" to sell limited partnership interests to joining managers or acquire limited partnership interests from leaving managers thereby facilitating the accession and departure of managers to and from the scheme.

Waterfall

The proceeds in case of an exit are paid and the PE investor and the management vehicle in line with the ranking of the relevant instruments they hold, the so-called "waterfall".

Yield

Income return on an investment, *e.g.* interest or dividends received from holding a particular instrument. In the context of an MEP, the yield on shareholder loans or preference shares is typically the interest rate or fixed income entitlement granted by such instruments.

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