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Employer Update

Senior Executives: Preparing for Elegant Departures — a Global Overview

By Ivor Gwilliams, Simon Gorham and Simon Lyell

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When recruiting a senior executive for a portfolio company, much of the negotiation on the terms of the employment contract and the equity incentive arrangements will focus on the terms that apply on termination of the relationship, e.g., the notice period/severance pay, the post-termination restrictive covenants and the leaver provisions in the equity documents. Whilst there are significant differences between the laws and practices across the U.S., Europe and Asia meaning that one size rarely fits all, there are some common themes that can be identified. Careful consideration, at the recruitment stage, of the issues that will need to be faced at the end of the employment relationship will help to ensure that the departure is as smooth as possible.

Notice periods and severance pay

The form of notice periods and severance pay will be driven both by market norms and local laws. In certain jurisdictions, statutory severance payments may be relatively modest in amount and may only apply in limited circumstances such as redundancy (e.g., the U.K.) or be non-existent (e.g., the U.S.). In these countries, an executive may demand long notice periods (e.g., the U.K.) or a lump severance payment triggered by termination by the employer without 'cause' or by the employee for 'good reason' (e.g., the U.S.). In other jurisdictions, particularly in continental Europe, statutory severance entitlements or those set out in collective bargaining agreements are more likely to have a bearing on the executive's separation terms. For example, in Italy, it is not uncommon for senior executives to be entitled to generous severance payments and notice periods which are set out in industry-specific collective bargaining agreements, and therefore there may be no need for the executive to request that such protections are built into their employment contracts. Therefore, when entering into new employment contracts with executives, the terms of those contracts should be considered in the context of the wider legal framework in which the employment contract sits.

Protecting the business – post-termination restrictive covenants

Businesses will usually want to be satisfied that post-termination restrictive covenants continue to apply to senior executives who are dismissed and, where enforceable, rely on penalty provisions if a senior executive breaches them. Post-termination restrictive covenants in employment contracts (such as covenants against competing and against soliciting clients and employees) are likely to be viewed critically in the U.S., Europe and Asia, where the courts will seek to balance the business interests of the employer against those of the senior executive but the rules can differ considerably across jurisdictions. It is sensible to include a separate set of post-termination restrictions in the agreement governing the equity incentive arrangements (e.g., shareholders' or investment agreement) because the courts may be willing to enforce restrictive covenants against individuals in their capacity as shareholders/investors more readily than against individuals in their capacity as employees, who are generally considered to have less bargaining power. It is also common to provide that shareholders'/investment agreements are governed by, say, English law and subject to the jurisdiction of English courts or arbitration, rather than the laws of the country in which the executive works, to provide greater certainty around how the restrictions in such agreement will be judged.

Unlike in the U.K. and Hong Kong, in certain European countries and in China, to ensure enforceability it is either advisable or necessary for the senior executive to receive compensation for some or all of the restrictive covenants arising from his employment. The amount of such compensation (e.g., 20% to 60% of the executive's pay) will typically be agreed in the employment contract (or the collective bargaining agreement) and is paid out over the duration of the restricted period, although the rules governing the amount to be paid and when payment is to be made can differ quite significantly across jurisdictions.

Leaver provisions in equity documents

Incentivizing executives through equity is a key feature of aligning their interests with that of the sponsor. The structure of these incentives is driven by the country of incorporation of the entity in which they will hold equity and the tax residency of the individuals. While in the U.S. it is more tax efficient for executives to receive stock options or profits interests rather than shares, generally the tax regimes in Europe and Asia means that executives prefer to hold shares.

Amounts invested by those executives alongside the sponsor (as investors rather than employees) will be invested in the same strip of securities as the sponsor, giving them proportionately the same economics. These securities tend not to be linked to employment, so if the executive leaves the securities are retained and sold at the same time as the sponsor. In contrast, "sweet" (or incentive) equity, for which an executive pays comparatively little and which provides the greatest economic upside on a successful exit, is tied to the contribution of the executive to the business. As an executive cannot contribute to the success of the business if he ceases employment, sweet equity is typically given up at that time.

While provisions can be tailored to each circumstance, vanilla leaver provisions would typically include the following:

- Sponsor can choose whether or not the executive has to transfer the securities (i.e., a call option of the company rather than a put option of the executive)
- Good leavers (i.e., executives who leave through no fault of their own, e.g., death, redundancy or serious illness) receive fair value for their securities (vesting over four or five years, with any unvested securities receiving the lower of cost and fair value)
- Bad leavers (i.e., executives who resign or who are dismissed for cause) receive the lower of cost and fair value for their securities
- If fair value cannot be agreed with the executive, an independent valuation is used (to save money, often the most recent quarterly third party valuation of the portfolio company for the limited partners of the sponsor)
- Fair value is calculated at the time the executive ceases employment (although if there are unusually long notice periods, this may be tied to the date the executive goes on garden leave or gives/is given notice)

- Also, in Europe and Asia often the securities are held through an employee benefit trust arrangement (where the beneficial interest is held by the executive, but the legal interest by the sponsor-controlled trust) which makes enforcement easier, although senior executives may push to hold their securities directly

As well as transferring any equity, it is important to ensure that if an executive is a director or officer of any group company, then he resigns from those positions when he goes on garden leave or ceases employment. When drafting the constitutional documents of the relevant entities, the removal process for any executive who is refusing to cooperate should be controlled directly or indirectly by the sponsor.

Summary of Key Dismissal Considerations Across Certain Key Jurisdictions

	Notice of Termination Periods	Statutory Severance	Unfair/ Unreasonable Dismissal Risk	Other Statutory Dismissal Protection	Other Termination Costs	Post-termination Restrictions (Non-Compete, etc.)
U.S.	Typically employment is 'at will' but there may be a contractual obligation to pay notice or severance pay	No	No	Discrimination; whistleblowing	N/A	Duration and enforceability varies depending on the U.S. state concerned. Typically, between 12 and 24 months from termination in an employment contract. No payment to the employee is required during the period of the restrictions. Typically, between 12 and 24 months in a shareholders' agreement
U.K.	Notice is typically between three and 12 months	Only for redundant employees with at least two years' service (capped at £14,250)	Yes – (basic award of up to £14,250 and a compensatory award of £78,335 or, if lower, one years' pay)	Discrimination; whistleblowing	N/A	Typically, up to 12 months from termination in an employment contract. No payment to the employee is required during the period of the restrictions. Typically, up to 18-24 months in a shareholders' agreement
France	Notice is typically three months in the applicable collective bargaining agreement. The employment contract may extend notice (e.g. to six or 12 months)	Yes – if the executive has at least one years' service: typically 20% of monthly salary per year of service up to 10 years' service, and 33% for each year in excess of 10 years, possibly more under applicable collective bargaining agreement	Yes – dismissal without serious and real cause; generally a minimum of six months' pay. Reinstatement may be ordered in certain circumstances (e.g. discrimination)	Discrimination; whistleblowing;	Yes – violation of the dismissal process; up to one month's salary	Typically, up to 24 months in an employment contact. Payment to the executive is required. Typically set out in collective bargaining agreement. Payment must be proportionate to the restriction imposed (typically 33% of average gross salary) and is paid for as long as the restriction lasts. Typically, up to 24 months in a shareholders' agreement

	Notice of Termination Periods	Statutory Severance	Unfair/ Unreasonable Dismissal Risk	Other Statutory Dismissal Protection	Other Termination Costs	Post-termination Restrictions (Non-Compete, etc.)
Germany	Notice is typically between three and six months	Yes – only payable on a business reorganisation (the amount is uncapped)	Yes – dismissal without a statutory reason; typically an expectation to pay 100% to 150% of gross monthly salary per year of service	Discrimination	N/A	Typically, up to 24 months in an employment contact. Payment to the executive is required (minimum of 50% of executive's most recent remuneration for duration of the non-compete). Typically, up to 36 months in a shareholders' agreement
Italy	Notice is determined by the employment contract or, more typically, by the applicable collective bargaining agreement and typically varies from six to 12 months	Yes – end of service allowance (calculated as gross annual pay (including bonus) divided by 13.5, or possibly more under relevant collective bargaining agreement)	Yes – compensation is normally set out in applicable industry-specific collective bargaining agreement, often calculated by reference to length of service and age Typically varies from 12 to 24 months' pay	Discrimination; whistleblowing	N/A	Typically, up to three months in an employment contact. 'Fair' payment to the executive is required, no specific minimum level but 25% to 50% of annual salary is typical. The same principles apply in a shareholders' agreement
China	Statutory notice is 30 days; longer notice may be unenforceable	Yes – calculated by reference to length of service and (capped) average monthly salary	Yes – In the absence of one of the limited statutory grounds for dismissal, the employer requires the consent of the employee to terminate employment; compensation is capped at two times statutory severance pay	Discrimination; whistleblowing	N/A	Typically, up to 12 months (but can be up to 24 months) in an employment contact. Monthly payments to the executive are required (if not otherwise stated) (typically 30% of average monthly salary). Typically, up to 24 months in a shareholders' agreement
Hong Kong	Notice is typically between three and six months but, if there is no agreed contractual notice, the notice period is deemed to be one month	Yes – only for redundant employees with at least two years' service (capped at HK$390,000)	No	Discrimination; whistleblowing	Yes – long-service payment for employees with five or more years' service (calculated using the same formula as for statutory redundancy pay)	Typically, six to twelve months in an employment contact. No payment to the employee is required during the period of the restrictions. Typically, between 12 and 24 months in a shareholders' agreement

Company Pensions in Germany

By Stephan Grauke, Mareike Pfeiffer and Johannes Allmendinger

Several, in particular large companies in Germany maintain, as an additional incentive for their employees, and generally on a voluntary basis, a pension plan fully or partially sponsored by the company. It is estimated that approximately 40% of all employees in Germany benefit from company pension plans. The total amount of assets and funds dedicated to cover pension liabilities, as well as of accruals set-up in balance sheets to cover "unfunded" pension liabilities, was EUR 538.5 billion in Germany in 2013. The majority of the corresponding pension liabilities (51.8%) are unfunded. In light of the considerable costs, there has been a tendency in recent years to close pension schemes. Such closures are, however, in general only permissible with respect to new hires, with the consequence that the pension liabilities existing as of the date of closure remain with the company for years and possibly decades, and decrease at a slow rate.

In the following article, we will provide an overview of the German pension system with a focus on the treatment of pension schemes in transactions, as well as in insolvencies.

Overview of German Pension System

The German pension system is based on three pillars:

- By mandatory law, all employees are subject to the statutory pension insurance maintained by the German state (i.e., the employer is not liable for it). The insurance is, in essence, financed by statutory contributions half borne by the employer and half by the employee (currently 18.7% in total of the individual employee's gross salary up to EUR 72,600 (Western Germany) or EUR 62,400 (Eastern Germany) per year ("**Salary Threshold**")).
- Unless mandatory under applicable collective bargaining agreements (*Tarifverträge*), companies can establish, on a voluntary basis, company-sponsored pension schemes. Once such a scheme is established, the company is bound to the German Company Pension Act (*BetrAVG*).
- Due to the demographic change and a predictable shortfall of the statutory pension, the German state supports private pension savings by granting tax and social security advantages. In this connection, the employees have a statutory claim against their employer to withhold up to 4% of their salaries up to the Salary Threshold and defer these funds to a pension scheme.

Funding Principles of Company Pension Schemes

Whereas a company pension scheme can be introduced in multiple ways (e.g., by unilateral promise of the company or by agreements with the employees, works council, or union), the set-up of the pension scheme has to be in line with the German Company Pension Act. The Act provides for the following five instruments (four thereof resulting in a "*funding*" of the pension liabilities):

- (unfunded) direct pension promise (*Direktzusage*)
- direct insurance
- pension cash funds (*Pensionskasse*)
- pension relief funds (*Unterstützungskasse*)
- pension funds (*Pensionsfonds*)

If the pension is funded via a direct insurance scheme, pension cash funds, pension relief funds or pension funds, the company pays contributions to the relevant external funding instrument. However, the company bears the capital investment risk *vis-à-vis* the employee, i.e., it is obliged to pay out at least the amount of pension promised to pay to its employees if there is a partial or complete shortfall of the funding instrument.

The only "unfunded" instrument provided for in the German Company Pension Act is the direct pension promise. As a consequence of granting a direct pension promise, the company regularly has to accrue the pension liabilities on its balance sheet. In practice, the company often enters into reinsurance policies to safeguard the pension liabilities. However, the value of a reinsurance policy may, in general, not be deducted from the pension liabilities that are to be accrued in the balance sheet pursuant to German GAAP. This situation changes if the company sets up a contractual trust arrangement ("**CTA**"), i.e., transfers assets to a trustee who is legally independent and may use the assets exclusively for the protection of pension liabilities. Although a CTA qualifies as a financing measure and not as a funding instrument in the meaning of the German Company Pension Act, the structure of a CTA generally allows a deduction of pension accruals in the balance sheet in the amount of the value of the plan assets transferred to the trustee under German GAAP.

Company Pension Schemes in a Share or Asset Deal Scenario

The direct or indirect acquisition of shares in a German entity that has funded or unfunded pension obligations does not have any impact on the pension situation at all: The German target entity remains as legal employer and, thus, the pension schemes and liabilities remain unaffected, as do any funding instruments established. This situation may change if the German target entity is part of a group and the group has set up its own funding instrument. In this case, the assets held by the funding instrument may remain with the group after the closing of the transaction, with the consequence that the carve-out of the German target entity results in an underfunding of pension obligations. However, this situation could be provided for under the share purchase agreement, either by the agreement on a transfer of plan assets to the target or by a respective purchase price deduction.

This situation is different in the case of an asset deal: Under German mandatory law, the transfer of assets that form a business unit results in all active employees attributable to this business unit transferring to the buyer with all employment-related rights and duties, including pension obligations. As a consequence, the buyer assumes all pension claims accrued by the employees actively employed with the business unit on the closing date of the transfer, with the claims being transferred in full to the buyer by operation of law. Pension claims accrued by individuals who left the business unit prior to the closing date (in particular pensioners and former employees) do not transfer to the buyer. A funding instrument in place (e.g., a direct insurance agreement or pension relief fund) does not automatically transfer to the buyer in connection with the asset transfer. Thus, a transfer needs to be agreed with the seller in the asset purchase agreement (and with the funding vehicle itself, if required). If the pension obligations *vis-à-vis* the transferring employees are unfunded, the buyer has to set up accruals for all pension claims of the transferring (i.e., active) employees. However, given that pensioners and other individuals who left the business unit prior to the closing do not transfer to the buyer, an asset deal scenario can result in a material deduction of pension liabilities for the buyer.

Company Pension in Insolvencies

According to German law, companies need to insure their pension obligations (other than those funded by pension cash funds) against insolvency with the Mutual Pension Assurance Association (*Pensions-Sicherungsverein auf Gegenseitigkeit*, "**PSV**"). The PSV has around 94,000 members (i.e., companies mandatorily contributing for insolvency insurance purposes) and protects the pension claims of approximately 10.9 million pensioners and employees with vested pension claims against insolvency of their employers. The value of the pension obligations insured by the PSV amounts to EUR 320 billion in total.

If insolvency proceedings are opened (or the application to open insolvency proceedings is refused due to a lack of assets), the PSV assumes, by operation of law, the liabilities for (i) current pension payments and (ii) pension expectancy rights vested according to the German Company Pension Act. The employees have a direct pension claim against the PSV. However, the PSV only assumes pension claims (or the *pro rata temporis* portion thereof) that relate to periods of employment prior to the date on which the insolvency proceedings are opened. The PSV is entitled to file its claims with the insolvency administrator as an unsecured creditor, ranking *pari passu* with all other unsecured non-subordinated claims.

The pension liabilities accrued until the date of the opening of insolvency proceedings will remain with the PSV even if employees of the insolvent company will be automatically transferred to a buyer in connection with an asset deal by operation of German law, i.e., in the case of insolvency, the buyer will only be liable on a *pro rata temporis* basis for pension claims that are accrued as from the day the insolvency proceedings were opened onwards.

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If you have questions concerning the contents of this issue, or would like more information about Weil's Employment Litigation and Executive Compensation & Benefits practices, please speak to your regular contact at Weil, or to the editors or practice group members listed below:

Editor:

Lawrence J. Baer lawrence.baer@weil.com +1 212 310 8334

Associate Editor:

Millie Warner millie.warner@weil.com +1 212 310 8578

Practice Group Members:

Jeffrey S. Klein
Practice Group Leader
New York
+1 212 310 8790
jeffrey.klein@weil.com

Frankfurt

Stephan Grauke
+49 69 21659 651
stephan.grauke@weil.com

London

Joanne Etherton
+44 20 7903 1307
joanne.etherton@weil.com

Ivor Gwilliams
+44 20 7903 1423
ivor.gwilliams@weil.com

Miami

Edward Soto
+1 305 577 3177
edward.soto@weil.com

New York

Lawrence J. Baer
+1 212 310 8334
lawrence.baer@weil.com

Gary D. Friedman
+1 212 310 8963
gary.friedman@weil.com

Steven M. Margolis
+1 212 310 8124
steven.margolis@weil.com

Michael Nissan
+1 212 310 8169
michael.nissan@weil.com

Nicholas J. Pappas
+1 212 310 8669
nicholas.pappas@weil.com

Amy M. Rubin
+1 212 310 8691
amy.rubin@weil.com

Paul J. Wessel
+1 212 310 8720
paul.wessel@weil.com