Joachim Herz Stiftung | GÖRG YOUR BUSINESS LAW FIRM | UNTERNEHMER TUM

LEC Legal Playbook

A Practical Legal Guide for Startup Factories and Mentors Supporting Founder Teams in Germany

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Introduction | Mission Statement

Purpose of this Playbook

This playbook is designed as a practical legal guide for individuals and organizations supporting founders in the German startup ecosystem, including startup factories, mentors, and other stakeholders. Its purpose is to provide a structured overview of the key legal topics that typically arise in the early stages of building a company, enabling mentors to identify relevant issues, ask the right questions, and guide founders toward informed decisions.

Early-stage entrepreneurs often face complex legal challenges while operating under significant time and resource constraints. Decisions made at incorporation, during initial financing rounds, or regarding intellectual property, employees, and commercial partnerships can have long-lasting consequences. This playbook aims to demystify these topics by focusing on the most common structures, risks, and best practices under German law, without attempting to replace tailored legal advice.

The content is intentionally concise, practical, and action-oriented. It highlights typical pitfalls, provides orientation checklists, and outlines “dos and don’ts” that reflect market standards and investor expectations.

The mission of this playbook is to empower mentors to act as effective sparring partners, contribute to the professionalization of early-stage ventures, and foster legally sound foundations for sustainable company growth.

Ultimately, mentors should use this document as a reference point to support discussions with founders, helping them recognize when specialist legal counsel is required.

UnternehmerTUM

Europe's Leading Center for Innovation and Business Creation

UnternehmerTUM is a unique platform for the development of innovation. UnternehmerTUM offers startups an all-round service from the initial idea to the IPO. A team of over 400 employees provides support in setting up the company, entering the market, and financing – including venture capital. A team of experienced consultants offers established companies optimal access to the UnternehmerTUM ecosystem.

UNTER NEHMER TUM

UnternehmerTUM has many years of expertise in the development of innovation strategies and the implementation and spin-off of technology-driven business ideas. Founded in 2002 by entrepreneur Susanne Klatten, the non-profit UnternehmerTUM GmbH is the leading center for Startups and innovation in Europe, with more than 50 high-growth technology startups every year – including Celonis, Konux, and Isar Aerospace.

Learning & Exchange Center

Germany is at the forefront of research but not of commercialization. Scientific findings are often not translated into marketable products, which hampers economic growth and innovation. University-affiliated startup centers are key in supporting young companies with infrastructure, mentoring, and networks. To boost this, Germany's Federal Ministry for Economic Affairs and Climate Action (BMWK) launched the "Startup Factories" competition. The goal is to support university-affiliated, privately organized, and entrepreneurially managed Startup centers, serving as incubators for future innovations and economic growth.

To support this initiative, UnternehmerTUM founded together with the Joachim Herz Foundation the "Learning and Exchange Center for Innovation and Entrepreneurship Practice" (LEC), backed by partners such as Boston Consulting Group, Stifterverband, Bundesministerium für Wirtschaft und Klimaschutz, Startup-Verband, and Baden-Badener Unternehmergespräche.

THE LEC OFFERS:

- **Strategic support & networking**
  Facilitating collaboration between startup factories, developing joint solutions, and fostering thematic knowledge exchange.
- **Knowledge generation & sharing**
  Collecting and analyzing national and international best practices, providing structured resources, and ensuring cross-factory learning.
- **KPI measurement & strategic steering**
  Establishing a data-driven framework to monitor, compare, and optimize Startup factory performance, ensuring transparency and continuous improvement.
- **Improving framework conditions**
  Optimisation of legal and financial conditions for startups and Startup factories.

"Our funding in science and research aims to have a systemic impact. One of the core concerns of the LEC is to establish an adapted impact measurement system for research funding in Germany."

Prof. Dr.-Ing. Dr. Sabine Kunst, Chair of the Joachim Herz Foundation

The **Joachim Herz Foundation** promotes the courage to start anew. It was founded in Hamburg in 2008 and is one of the largest German foundations. It is committed to innovation and supporting the transfer of cutting-edge research into practice so that this important work generates social benefits and does so quickly.

It strengthens startup ecosystems and works to foster a new generation of entrepreneurial talent dedicated to sustainable business models and radical innovation. It is also helping to renew vocational training so that young workers are prepared for a working world that is being transformed by AI and digitalisation. The foundation's aim is to provide effective solutions to current challenges such as climate protection, resource scarcity and the skilled labour shortage.

Joachim Herz Stiftung

GÖRG – founding, funding, scaling, exit!

For many years, our venture capital experts have been advising VC funds, start-ups and growth companies throughout the entire start-up lifecycle, from foundation to growth, international expansion to exit. Their interdisciplinary expertise puts our teams in a perfect position to service clients on any business law topics relating to complex transactions, projects, cooperations, as well as other strategic decisions.

GÖRG is a full service and independent German law firm with more than 370 lawyers, tax advisors and auditors in five major offices in Germany. As one of the leading German business law firms, we have comprehensive expertise in all relevant areas of business law.

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1. INCORPORATION

Incorporation is the first formal step in transforming an idea into a legally recognized business and lays the foundation for all future activities of a startup.

A key question is timing: from a German law and tax perspective, incorporation should generally take place *before* the business commences operations – i.e. before the team appears publicly vis-à-vis customers, suppliers, startup competitions, or otherwise – since premature activity can trigger unintended tax and liability risks.

This chapter outlines the incorporation process, including key steps and required documentation, and is complemented by FAQs and a practical checklist to help avoid common pitfalls at this critical stage.

a. Process of Incorporation

- Founders incorporate the Startup GmbH and personal holding UGs
- Requires
  – incorporation articles of association, and
  – due representation of each Founder (but possibility of online incorporation)

- Founders open bank accounts of the Startup GmbH and personal holding UGs
- Requires notarial incorporation deed(s)

Notarial incorporation meeting → **Opening of bank account(s)**

- Founders are required to pay
  - at least half of the nominal share capital, i.e. EUR 12’500, as well as,
  - the nominal share capital of their personal holding UGs

Payment of nominal amounts

- Following payment of nominal amounts, the managing directors confirm payment to acting notary
- The acting notary files the incorporation documents with the commercial register
- The commercial register processes and registers the newly incorporated companies

Filing & registration with commercial register

b. FAQs

The following outlines questions frequently asked by founder teams in the context of incorporation:

Do we really need personal holding entities to hold our shares in the startup company?
In essence: yes, please do it. Holding shares in the startup company via a personal holding entity is fairly market standard, mainly due to two tax considerations:

- 95 % tax exemption: proceeds (e.g., exit proceeds) received on the level of the holding entity are 95 % tax free. They will be taxed once distributed to the founder personally (or spent by the holding entity for the founder's personal matters). However, such exit proceeds may e.g., be re-invested by the holding entity without being taxed before.

- Avoiding dry-income: if proceeds received by founders in an exit are other than cash (e.g., shares in the acquiror), a direct participation might result in a (much higher) dry income scenario. Solving this in the context of exit is generally possible but will result in extra cost and likely prolong the exit process – both causing additional stress that you do not want to have.

Personal holding entity means that each founder is the 100 % owner of their individual holding entity. Every other structure (joint holding entities with spouses, co-founders, etc.) is likely to be considered off-market by VC investors – before implementing another structure, founders should consult legal counsel.

Can we incorporate the startup company and our personal holding entities in one notarial meeting?
Yes, this is the usual way to incorporate. The notary will file the incorporation of the personal holding entities first and the startup GmbH later on.

One member of our founder team is currently still engaged in XYZ – can we still incorporate the company and let him acquire his shares at a later point in time?
In essence: not without consulting legal and/or tax counsel first. A so-called late co-founder will always want to acquire the shares at their nominal value (i.e. EUR 1.00 per share). If tax authorities take the view that the shares acquired by a late co-founder are worth more than EUR 1.00 at that point in time, the difference between such value could be taxed at the personal income tax rate of such late co-founder. Since the late co-founder has not acquired liquid assets to pay such tax, this is called a dry-income scenario.

Tax authorities could assume such a higher value e.g., because the company has already generated first revenues, conducted an equity financing round, obtained material financing through convertibles or entered into such financing in temporal connection with the acquisition of the late co-founder.

How long does it take to incorporate?
From the notarial meeting to the registration of the personal holding entities and the startup company with the commercial register, the process will usually take approx. 3 to 6 weeks (depending on the commercial register's workload).

Is it possible to expedite the process?
The best way to expedite the process is to plan ahead and informing every party involved of your targeted timeline. In particular, this means the notary and your bank. Opening an account at the bank will require a copy of the notarial deed of incorporation. Once the account is open, you can pay in the nominal amounts and provide the notary with a respective confirmation. Only then will the notary file for registration.

Planning ahead in this sense means:

- Inform the bank that you plan to open bank accounts for newly incorporated entities (startup and personal holding) before your notary appointment.

- Ask them what documents you may provide in advance (e.g., KYC documents, in particular for non-EU citizens).

- Tell them when you will provide them with the deed of incorporation and ask them to inform you immediately when funds can be paid in.

- Let your notary know that you plan to start operations with your entity as soon as possible.

Can the company sign agreements or act vis-à-vis third parties prior to registration?
The company is incorporated upon signing the deed of incorporation. Until registration with the commercial register it is "in incorporation" (GmbH i. Gr. – in Gründung).

Founders should be aware that entering into agreements on behalf of the company before its registration entails a legal risk. During the pre-registration phase (i.e., while the company is "in incorporation"), the managing directors – and, in certain cases, all founders – may be held personally liable for obligations incurred by the company. If the company is ultimately not registered, the founders may face unlimited personal liability for all commitments entered into on behalf of the company. Even if registration is completed, personal liability may persist where the company's assets are insufficient to cover obligations assumed during the pre-registration phase. It is therefore advisable to limit any contractual commitments prior to registration to the extent possible and, where unavoidable, to clearly indicate the company's status as "in incorporation" (i.Gr.) in all dealings with third parties.

What are the incorporation articles of association?
Every German limited liability company (GmbH) is required by law to have articles of association that govern the basic relationship between the company and the shareholders. This is a public document that everyone can download for free from the commercial register. The articles of association agreed upon at incorporation are typically restated in their entirety as part of the first equity financing round (i.e., when the first investors come in).
It is therefore a document that should be done properly, but with reasonable efforts and cost.

Do I have to engage legal counsel to draft the incorporation articles of association?
No. Most notaries have a standard template for incorporation articles of association which – if the notary has a particular focus on venture capital – might also include vesting provisions.

Nonetheless, law firms focused on working with early-stage startups typically have their own template documents, including vesting clauses, which they may send (and even discuss with) you for free. Most of these law firms are not interested in "making money" from a startup's incorporation and are aware of budget constraints. They are investing in a relationship with early-stage startups in order to be engaged in financing rounds.

As regards the personal holding entities, the notary's template may be used in any case.

Should we also enter into a separate shareholders' agreement?
In most cases, a separate shareholders' agreement (or vesting agreement) is not very sensible. Typically, such agreements require notarization and thus result in additional and considerable costs. Clauses such as vesting can also be agreed upon in the articles of association. Yes, they are public, but it is hardly a secret for a newly incorporated startup that shareholders agree upon vesting.

What is vesting, and do we need to agree on it right from the start?
Think of vesting as a matrimonial agreement among the founders (and other shareholders) – vesting provisions govern the legal effects of a founder leaving the company or ceasing to be actively involved in its operations. Typically, in the early startup stages, a departing founder loses all or a big part of their shares at no or very low consideration (depending on the circumstances of departure).

Vesting provisions are a non-negotiable request from institutional investors, i.e. there will be a vesting after the first equity financing anyhow.

A founder's departure without enforceable vesting provisions may paralyze the operational business of the company for months – thus vesting provisions also protect the company and non-departing founders. It is therefore strongly advisable to agree on them at incorporation.

We have already started doing business and hold substantial IP rights/assets/prize money – how do we transfer it to the startup company?
This is an item on which advice from a lawyer or tax advisor is mandatory, even at incorporation. Transferring pre-existing business, IP rights, assets, or funds to the company may result in a material tax risk if not done properly. Whether such a tax risk arises depends on several criteria, among others:

- What significance do these activities, IP rights, and other assets have?
- Have there already been sales revenues?
- When is the first prized equity financing round envisaged to occur?

Should we all be managing directors?
There is no right or wrong here. It is important to know that (1) not every founder must be managing director and (2) being managing director comes with certain responsibilities (and therefore liability risks) that "normal" employees do not have.

As one example, in the case of insolvency grounds, it is the managing director's duty to file for insolvency. Omitting to do so may result in liability for damages to creditors as well as criminal charges. In founder teams of 3+ individuals, it is often the business and finance guys who assume a role as managing director, with the other founders having other C-level positions and competencies.

c. Checklist for incorporation

Before the notarial meeting

1. Agree on founder team, shareholding %, vesting provisions, names, managing directors, etc.
2. Consider pre-existing business/assets and, if any, engage legal or tax counsel
3. Obtain a proper template for the articles of association from a VC-specialized legal counsel
4. Make a notary appointment
5. Inform your bank of the envisaged timeline
6. Individualize the incorporation articles of association
7. Ensure that all founders are present during the notarial meeting – online incorporation is possible, subject to certain requirements

After the notarial meeting

8. Provide your bank with the incorporation deed as soon as possible
9. Once bank accounts are opened, transfer the required nominal amounts (for GmbH initially min. EUR 12'500, i.e. half of the min. registered share capital)
10. Confirm receipt of payment to your notary for registration filing


KURS

2. First Financings

Securing initial funding is a pivotal step for startups and often determines both their growth trajectory and ownership structure. This chapter provides an overview of the most common early-stage financing sources and explains key instruments such as convertible loans, equity rounds, and non-dilutive funding.

It further outlines the essential concept of dilution, and highlights the importance of term sheets while also giving an overview of the core provisions of a venture capital equity financing term sheet, market standard terms included therein and a range of negotiation.

The objective is to enable mentors to give founders a better understanding of both economic and legal implications of early financing processes.

a. Basic considerations on cap table composition

Before giving an overview of financing options in early stages, it is important to understand a few basic principles on cap table composition and the “planning of the equity story”:

Keep it short & simple

In principle, VC cap tables should be kept short and simple. Every additional shareholder increases complexity and poses an additional obstruction potential, particularly when they do not have professional participation management.

Small shareholders

Shareholders with a shareholding of less than 3-5 % are typically engaged because they bring other qualifications or assets to the table, whether it is opening doors, special know-how, or actual involvement in the operational business. Founders should think twice before engaging micro investors without any special qualifications.

Pooling

If founders decide to engage small investors such as family/friends or business angels, they should ensure that these investors agree to customary pooling options. All pooling options have in common that they aim to reduce the complexity and administrative efforts of multiple smaller shareholders by allowing others to exercise their shareholders’ rights (typically after giving them the opportunity to vote on the relevant matter). **Pooling does not nullify complexity and administrative efforts; it can reduce it.**

b. Overview of financing sources in early stages

The following provides a brief overview of financing sources in early stages:

I. FAMILY, FRIENDS AND "FOOLS"
Financing from family members, friends and other "acquaintances" is typically obtained via convertible loan agreements (or a SAFE). This can be a viable option for initial funding with typical ticket sizes between EUR 10'000 to EUR 50'000 and a total round size in a range of EUR 250'000. Founders often opt for this if financing from business angels or institutional investors cannot be obtained.

This source of financing typically results in multiple smaller shareholders and requires a commitment from those shareholders to customary pooling (which can be directly included in the convertible loan agreement).

II. BUSINESS ANGELS
Business angels are individual investors, mostly without professional participation management, that invest in startups with typical ticket sizes from EUR 25'000 and EUR 100'000, often via convertible loans (or SAFE). Super angels sometimes invest more. Many business angels are former founders who have successfully exited their company or senior/ex-managers of big corporates. Therefore, they might fit the criteria of "bringing other qualifications to the table" (see above) and can be valuable sparring partners for founders.

If this is an option, founders should (i) conduct their due diligence on their people, e.g., by contacting other startups in which the business angel has invested (websites like NorthData can be a good reference point to identify these startups) and (ii) obtain a commitment to customary pooling (see above).

III. INSTITUTIONAL VC INVESTORS
VC investors are institutional or professional investors focusing on high-growth startups and scaleups. Their investment strategy is typically exit-driven, aiming to generate outsized returns on a few successful investments to compensate for losses across the portfolio, with successful investments often targeting returns in the range of 5–10x or more.

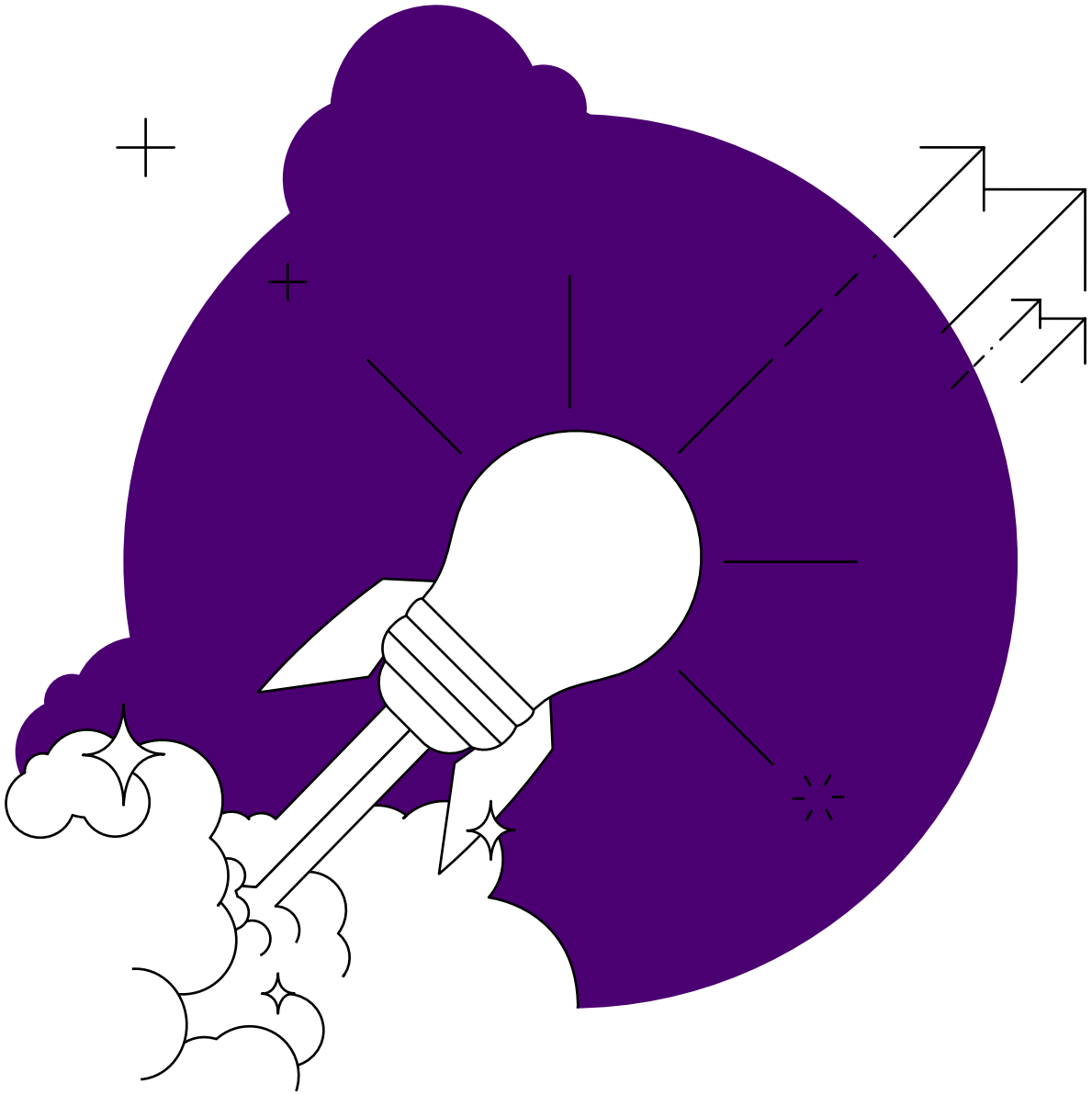
Since such a return on investment can be achieved in approx. one out of ten investment cases, they invest in a large number of startups. This has led to a certain standardization in the provisions under which they invest and in what they consider a minimum common ground with other investors and the founders.

Institutional VC investors can generally be divided into two sub-groups: private VC investors and genuine public money VC investors. While private VC investors raise funds from a wide spectrum of investors (incl. also public investors), genuine public money investors like EIC, HTGF, Coparion, and BayernKapital are primarily funded by the EU or German federal or local state (in the case of HTGF, alongside private co-investors). This form of public economic promotion leads to certain additional rules of investment, which may differ depending on the individual public money investor.

Some of them only invest by mirroring private lead investors, both in the amount of funds deployed as well as the terms of investment. For founders, it is important to understand the investment principles of individual public money investor. Local state-funded public money investors typically only invest in startups that have a certain link to their respective state (e.g., because their seat is in the respective state or because they employ a certain number of individuals in the respective state).

IV. CORPORATES AND CORPORATE VC INVESTORS (CVCS)
Another type of VC investors are established corporations. These investors vary materially in their form of organization (investments "off the balance sheet" vs. separate and independent entities), motivation (strategic vs. financial), and involvement (cooperative vs. hands-off).

For founders, it is vital to quickly understand which type of corporate VC they are talking to, and to only look out for corporate funding if there is a dedicated VC unit handling it. While all CVCs seem to have their raison d'être, startups should be cautious to engage strategically motivated corporate VCs, should they request individual strategic rights, diverting from the "minimum common ground" or standard VC rules of play that institutional VCs



require. In a worst-case scenario, early investments by strategic CVC can endanger the startup's future fundability for "traditional" VC investors.

Another important aspect to note is that in recent years, several corporates have materially reduced their VC activities or even closed down their VC units, while this development can be explained by the general economic situation.

This being said, there remain many corporate VC investors that understand the rules of VC and are a beneficial addition to a startup's cap table.

V. GRANTS AND OTHER NON-DILUTIVE FUNDING

Last but certainly not least, the European Union, Germany and local states provide for a rich landscape of non-dilutive funding for startups ranging from grants and subsidies over tax benefits to hybrid instruments.

Instruments available may vary from state to state and also depend on the area of business of the startup. The application process for some of these instruments is rather complex or requires time which has led to the rise of an industry of grant advisors that guide startups through application processes. The majority of these advisors provide helpful services at a reasonable fee level (often structured as a "success fee") with some exceptions charging disproportionately high fees measured against the scope of their actual services. Founders should carefully review engagement letters and understand in which cases fees apply – long-tail periods or excessive scope must be avoided.

c. Convertible loans (and SAFE)

Convertible loans are a widely used early-stage financing instrument, particularly in the pre-seed phase (e.g., business angel financing rounds). In essence, investors provide the company with a loan that converts into a certain number of shares in the company upon agreed conversion events (one of which is typically an equity financing round). The calculation of these conversion shares is typically based on the valuation of such equity financing round with discounts and/or valuation caps applying.

The agreements are rather short (often between 10 to 20 pages vs. ~100 pages or more in case of equity financing documentation) and can be negotiated quickly, which results in typically rather low fees for legal counsel.

So where is the catch?

A central legal and practical challenge lies in precisely structuring the conversion mechanics. Key terms – such as the definition of a qualified financing round, the applicable discount or valuation cap, maturity dates, and treatment in exit scenarios – must be clearly drafted and consistently understood by all parties. Ambiguities or divergent expectations can lead to disputes, unintended dilution effects, or even deadlock situations at the time of conversion. Some of these risks may be managed by aligning on a sample conversion calculation prior to signing the convertible loan agreement (or even attaching it to the deed) .

Secondly, convertible loans may appear to be "cheap money" because they only dilute the founders upon conversion. It is important for founders to always have a clear view of all outstanding convertible loans and their effect on the envisaged next financing round or other conversion event (e.g., maturity).

Finally, founders should anticipate their future equity investors' view on the conversion terms. Equity investors may oppose conversion terms that are, in their view, too beneficial for convertible loan holders and would give them an unreasonably high shareholding percentage in the company. Such terms can endanger future financing rounds and harm the fundability of the company.

As regards the formalities, there has been some legal uncertainty as to whether convertible loans are subject to notarization since an unfortunate ruling by the Higher Regional Court of Zweibrücken in 2022. The ruling is viewed critically by many practitioners and, in some cases, by courts, and there are very good arguments for eliminating the notarization requirement. Therefore, practice is inconsistent. Investors and startups may decide to accept this legal risk, and often do when investments are rather small and provided by internal investors only. However, a risk of invalidity and/or unenforceability if notarization is not carried out remains in all cases, since the Federal Court of Justice (as the highest civil court) has not yet ruled on the issue. Irrespective of the notarization question, founders acting as managing directors should ensure that any subordination of claims (*Rangrücktritt*) included in the convertible loan agreement is effectively drafted, as a defective subordination may result in an over-indebtedness (*Überschuldung*) of the company and trigger the managing directors' personal liability for failure to file for insolvency.


TECH
FOUNDERS

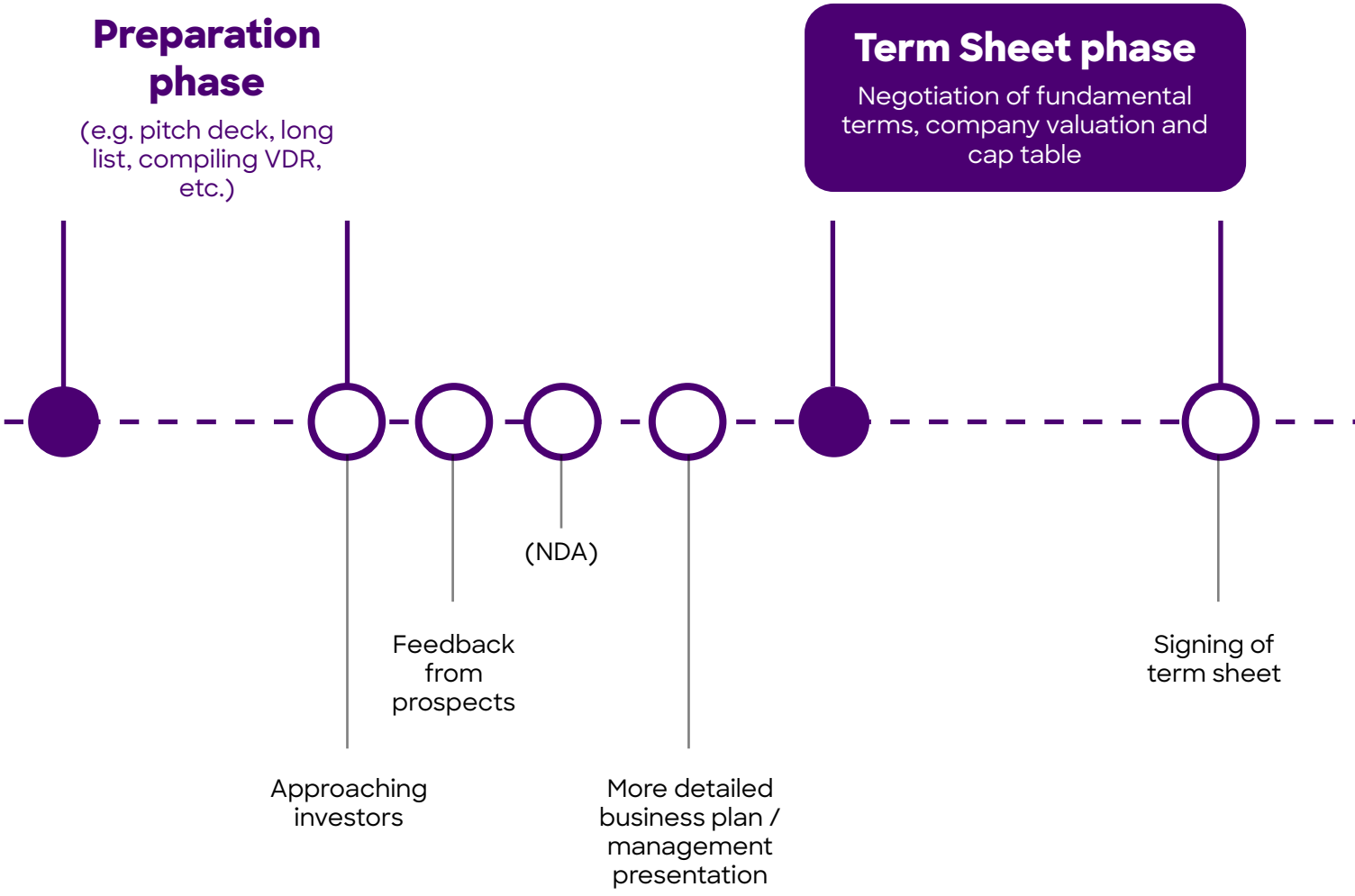
d. Equity financing round

Equity financing rounds are a central milestone in a startup's development, providing fresh capital in exchange for newly issued shares at an agreed valuation. Unlike convertible instruments, they require founders and investors to align on the company's valuation and key investment terms upfront. This chapter outlines the typical process of an equity round, including the role of term sheets, key contractual provisions, and the allocation of rights between shareholders. It also highlights the legal and economic implications for founders, particularly regarding dilution, control, and future financing flexibility.

I. PROCESS OF AN EQUITY FINANCING ROUND

The process of an equity financing round can be roughly described in three distinct phases.

In the **PREPARATION PHASE**, the startup company initiates fundraising by preparing documents such as a pitch deck, a business plan, and/or management preparations and identifying potential investors. To approach potential investors, founders need to first identify their funding requirements. These are often defined by the road to the follow-on investment round. Founders should ask themselves, what do we need to justify the next big leap in valuation. This could range from finishing a prototype to achieving specific ARR KPIs. The expenditure

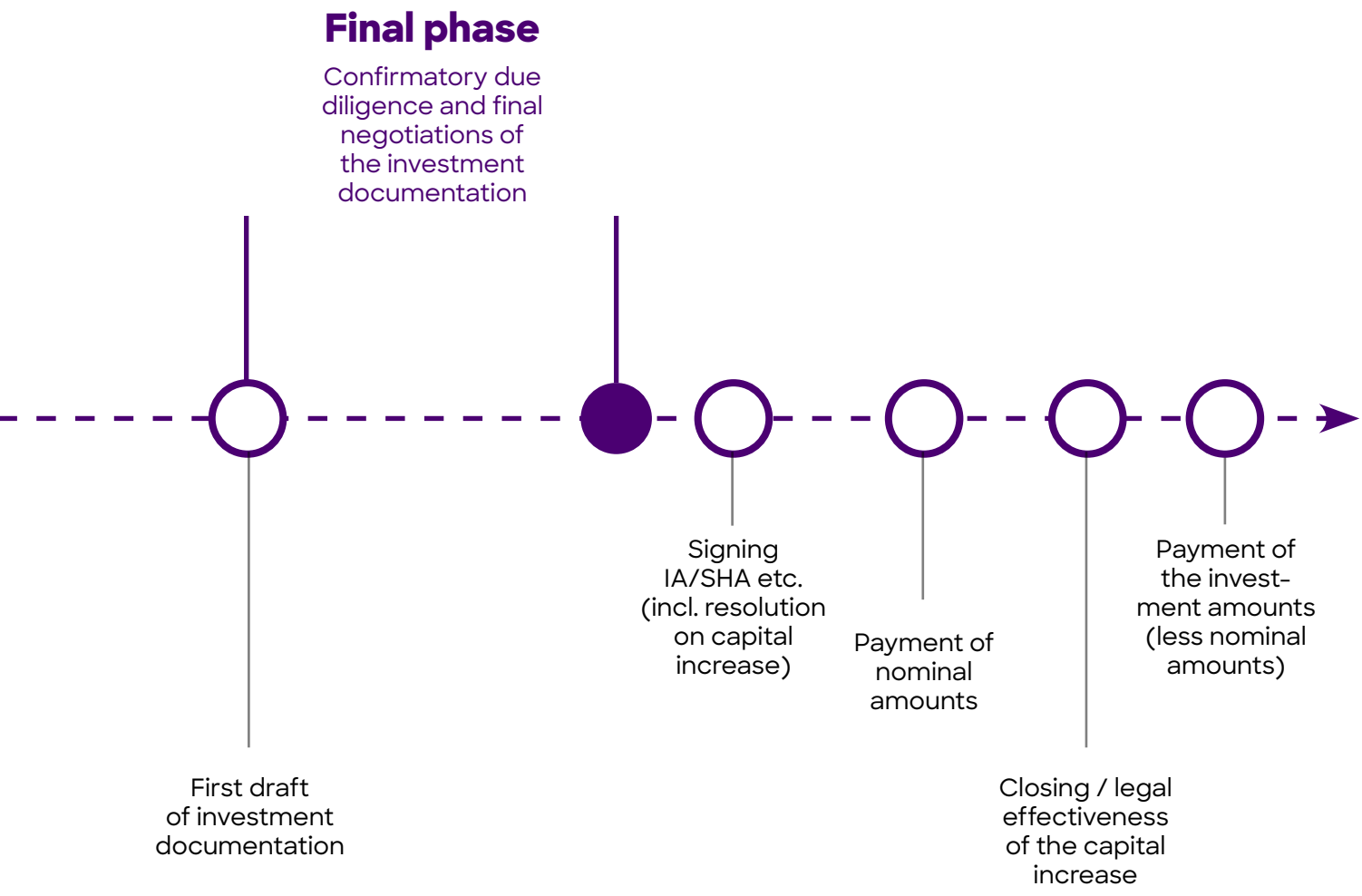


and runway required to achieve that goal (plus a buffer of ~20-25%) tells founders what funding is required today. Timing is a central aspect when approaching these investors and should be coordinated in a way to ensure that the startup receives several offers/term sheets from the relevant investors at the same time. Only then can founders compare different offers/term sheets and leverage their alternatives, resulting in a stronger negotiation position.

Another key task for the company in this phase is preparing a virtual data room containing the documents typically required by investors for their due diligence. In early-stage transactions, the scope is usually relatively focused to manage costs, while still covering all critical areas of the business. Legal due diligence at this stage typically includes a review of the company's corporate structure (including, where applicable, its incorporation, employee participation schemes, share transfers, and leaver provisions), as well as template employment and/or freelancer agreements, with a particular focus on IP ownership and non-compete provisions. It also includes a review of the company's IP position, in particular, whether all IP rights material to the business are duly owned by or validly licensed to the company. Beyond legal due diligence, early-stage investors typically focus on the company's product-market fit (including traction metrics, customer feedback, and competitive positioning), the strength and complementarity of the founding team, the plausibility of the business plan and financial projections, as well as the size and accessibility of the target market.

Due diligence may be conducted in different stages, the first of which could also commence in the preparatory phase. It is therefore key to prepare a virtual data room early to reduce workload in later stages and maintain a professional impression.

The preparation phase closes, and **TERM SHEET PHASE** begins with the negotiation of one or several



term sheet(s). The term sheet is one of the most important documents of the equity financing round. Its purpose is to summarize the key commercial terms of the transaction, define an efficient process and timeline, and grant a certain level of transaction security for both parties.

Primarily, it is a commercial document that confirms the joint understanding among the company/founders and the lead investor of the financing round. Negotiating it is the core competence of one or several founders. Advisors are rarely part of the discussion but may provide valuable insights in the background; a VC financing round term sheet can be analyzed by an experienced VC lawyer in under an hour, with any findings being discussed quickly over the phone.

It is important for founders to understand that the term sheet phase is generally the most defining moment of the transaction, as it sets the stage for the final phase of the transaction. As a rule of thumb, it is also the moment when the company and its founders have the most negotiation power, in particular when more than one term sheet is on the table. After signing the term sheet, this negotiation power is often severely reduced since the decision for one investor has been made, and due to negotiation exclusivity under the term sheet, other options are no longer a threat to the investor. Therefore, all items important to the company and its founders should be expressly included in the term sheet. Moving the negotiation on critical items to a later stage is rarely a good idea, as it will be more of an uphill battle than in the term sheet phase. To check whether all important items are included, a brief sparring session with an experienced advisor can be helpful.

Once the term sheet is signed, the **FINAL PHASE** commences. It includes the drafting and negotiation of the long-form transaction documentation (which is often in a range of 100 pages plus annexes) based on the term sheet by legal counsel, a (confirmatory) due diligence by the investor and its advisors, and finally the signing and implementation of the transaction by issuing shares to the investors.

Investors will typically invest in a so-called two-step, with the nominal amount of shares (i.e., EUR 1.00 per share) being paid directly after signing, and the vast majority of the investment (i.e., the agio or additional payment) being paid upon registration of the capital increase in the commercial register. Registration typically takes between 1.5 and 3 weeks, but can in individual cases also take longer. Founders should keep this in mind when planning the financing round and calculating the runway.

II. UNDERSTANDING DILUTION: PRE-MONEY VALUATION, FULLY DILUTED BASIS, AND SHARE PRICE

One key economic aspect of the transaction for founders and other existing shareholders is the dilution of their stake in the company which is the result of issuing new shares in the company to investors, thereby reducing the shareholding percentage of existing shareholders.

The number of shares to be issued to investors is calculated by dividing their investment by the share price of the financing round. The share price is typically calculated by dividing the company's pre-money valuation by its fully diluted share capital.

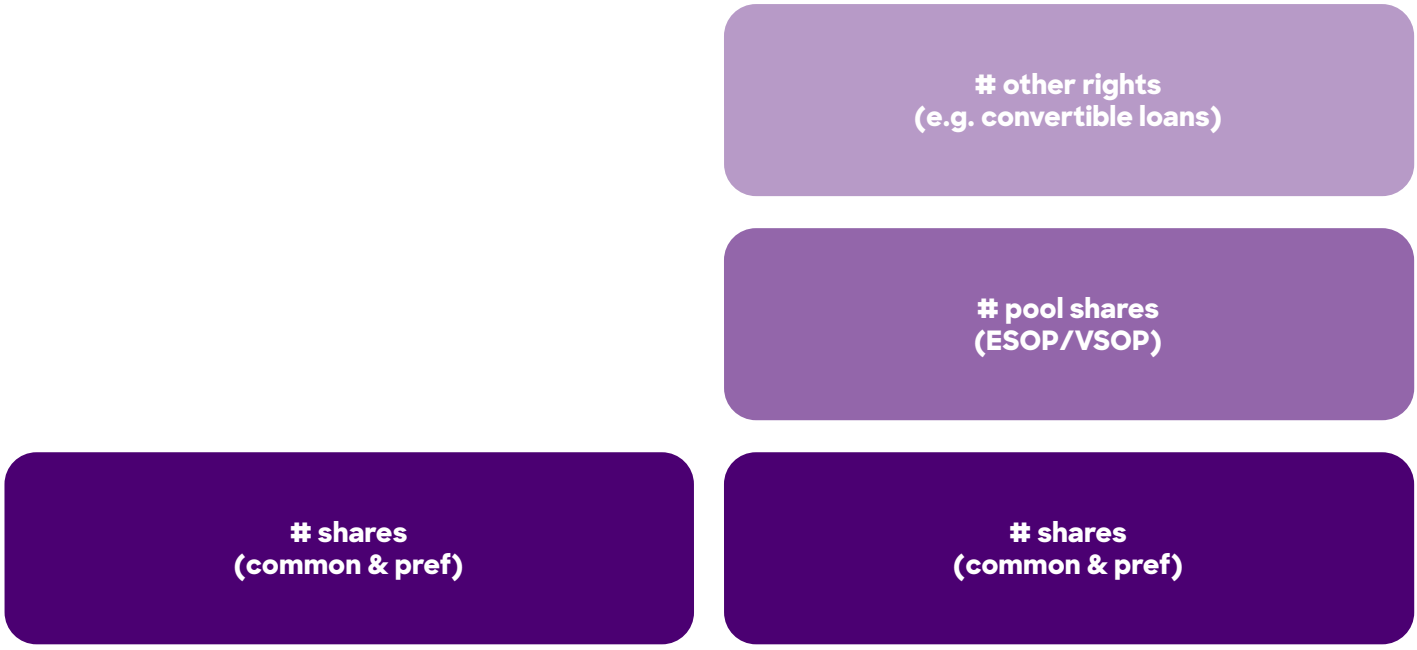
There is no industry-wide standard or clear-cut definition of the fully diluted share capital, but a range of market practices. In essence, the fully diluted share capital (*vollverwässertes Stammkapital*) refers to the registered share capital (*Stammkapital*) plus certain outstanding rights and instruments that convert into real shares in the company or participate in exit proceeds and/or profit distributions.

Such rights or instruments include convertible loans, considering their conversion based on the terms of the equity financing round (i.e., "as converted"), as well as employee participation programs (e.g., VSOP, profit participation rights, etc.), warrants entered into as part of venture debt financings, etc.

It is important for founders to understand the effect of a broader or more narrow fully diluted share capital. Broadening the fully diluted share capital results in a lower share price, more shares to be issued to investors, and thus, a higher dilution for existing shareholders. Therefore, a nominally lower pre-money valuation applied to a narrowly defined fully diluted share capital may result in less dilution for founders than a higher headline valuation paired with a broadly defined fully-diluted basis.

A typical negotiation item in the course of a first financing round is the question of employee participation programs. If not implemented already at the time of the financing round, both founders and investors will typically want to implement an employee participation program going forward. The question is "when" such a program will be implemented. If implemented "before" the financing round, the employee participation program would typically be considered in the fully diluted share capital, thus lowering the share price and increasing dilution of existing shareholders. For founders, it is therefore typical to push for implementation of the employee participation program "after" the financing round so that the dilutive effect is borne by existing shareholders and investors alike.

But even in a scenario where the founders do not succeed in the negotiation, and the employee participation program is considered as part of the fully diluted share capital, the described effect may be compensated by increasing the pre-money valuation accordingly – think of it as communicating vessels.



III. TERM SHEETS: OTHER IMPORTANT TERMS TO NEGOTIATE

The following explains other specific terms that are often found in term sheets for VC equity financing rounds, providing both a brief summary of the term as well as a range of market practices that can be negotiated (where applicable). In particular, for first-time founders, preparation is key since typically the counterpart in such negotiations will have negotiated many term sheets before. It is essential for founders to know the terms in their different varieties as well as the typically negotiable range, not only in order to avoid unintended outcomes but also to gain confidence:

1. Milestone-based investment

Milestone-based investments in venture capital financing refer to an agreement according to which the funding amount is only released incrementally, based on the startup company's ability to achieve certain predefined goals or "milestones". Instead of receiving the entire amount of investment upfront, the startup receives a portion of the capital at the outset and additional funding only when the agreed milestones are achieved by the agreed due date.

These milestones are often tied to quantitative or qualitative key performance indicators (KPIs) such as

- Product development, e.g., launching a beta version or achieving product-market fit;
- Revenue growth, e.g., reaching a certain level of monthly or annual (recurring) revenue;
- Customer acquisition, e.g., hitting a specific number of active users, customers, or pre-orders;
- Regulatory approvals, securing necessary licenses or clearances;
- etc.

As you can imagine, agreeing on clear and unambiguous milestones can be a challenge, as is the question of what shall be the consequence if an agreed milestone is not achieved or only partially achieved.

In principle, there are three possible options to govern the issuance of shares and payment of respective investments:

- Option 1: the issuance of shares and payment of respective investments occurs concurrently upon the fulfillment of the milestones. This is considered the most "founder-friendly" approach.
- Option 2: all shares are issued directly upon signing of the financing round. Should the respective milestone not be fulfilled, and the investor does not pay the milestone investment, shares in a respective number can be redeemed by the company. This is a balanced approach and, from a founder's perspective, rather close to option 1.
- Option 3: all shares are issued directly upon signing of the financing round, but the company cannot redeem shares in case a milestone is not fulfilled and the milestone payment is not made. This is essentially not a milestone investment but a re-valuation of the financing round. From a founder's perspective, this should be avoided (or at least mitigated by agreeing on clearly defined milestones that are achievable at highest likelihood).

2. Liquidation preference

A **liquidation preference** describes the preferential distribution of proceeds from an exit transaction or dividends to certain shareholders (e.g., investors or holders of so-called preferred shares), up to a certain preference amount (e.g., one-time (1x) an investor's investment amount or a multiple of it).

There are two main types of liquidation preferences:

- A **non-participating** liquidation preference (*anrechenbare Liquidationspräferenz – NB: do not get confused with the translated terms of participating vs. non-participating*) means that after an investor has received its preference amount, it does not participate in the pro-rata allocation of the remaining proceeds to other shareholders (e.g., the founders as holders of common shares) until such other shareholders "catch up" (i.e., have obtained proceeds that reflect their pro-rata shareholding in the company). After the other shareholders have caught up, the proceeds will be allocated to all shareholders pro rata.
- In a **participating** liquidation preference (*nicht anrechenbare Liquidationspräferenz – NB: do not get confused with the translated terms of participating vs. non-participating*), investors not only receive their preference amount at first, but afterwards immediately participate in the pro-rata allocation of remaining proceeds alongside other shareholders without any catch-up. It's like the repayment of a shareholder loan.

In early-stage VC transactions in Germany, 1x non-participating liquidation preferences are prevalent, but participating preferences are not uncommon in situations where investors have stronger negotiating leverage or at particularly high valuations.

3. Downround protection

A **downround protection clause** is a provision designed to protect investors if the company raises a new round of funding at a lower price per share than a previous round (a so-called downround). The clause gives previous investors the right to subscribe for additional shares. The number of additional shares is calculated by adjusting the share price paid by the previous investor based on the lower price.

There are different methods of adjusting the previous share price:

A **weighted average** calculation takes into account both the previous share price and the lower share price, resulting in an average share price between the two of them. There are two common types of weighted average calculations deviating in the number of shares at which the previous share price is taken into account:

- A **broad-based weighted average** takes into account (i) the lower share price at the number of shares issued at such price in the downround and (ii) the previous share price at a relatively higher number of shares (e.g., the number of shares issued to the respective investor at the previous price plus all common shares and employee incentives shares or options)

- A **narrow-based weighted average** takes into account (i) the lower share price at the number of shares issued at such price in the downround and (ii) the previous share price at a relatively smaller number of shares (e.g., the number of shares issued to the respective investor at the previous price).

A **full ratchet** calculation only takes into account the lower price per share, essentially resetting the price per share paid by the previous investor to the downround price per share. Full ratchet calculations have been described as a “sledge-hammer approach” to downround protection by notable VC investors and are rather uncommon in the German market. They do pose a risk of disrupting the cap table and endangering future fundability.

4. Governance and reserved matters (incl. board composition and majorities/veto rights)

Governance refers to the overall structure and mechanisms by which the startup is managed and how decisions are made at the different levels, i.e., (i) the management, (ii) the board, and (iii) the shareholders.

Reserved matters refer to the specific rights, controls, and decision-making processes that investors negotiate to protect their interests and influence key decisions within the startup company. These typically involve strategic or high-impact decisions (i.e., decisions on matters outside the day-to-day business) that require the **approval of investors** at either the shareholders' or the board level.

Typical reserved matters at the board level include, e.g.:

- Approval of the annual business plan;
- hiring or terminating managing directors or key employees;
- raising of debt;
- any agreement on or disposal of IP rights;
- any agreements between the startup and any of its shareholders or related persons;
- etc.

Board composition: The size of the board (i.e., the overall number of voting board members) in early-stage startups generally ranges between three and five voting members. Major investors typically negotiate for representation on the company's board (in German startups called the advisory board or *Beirat*) through a **voting board member**. Additionally, investors often ask for the right to delegate a **board observer**, i.e., delegates of such investor who have the right to participate in board meetings to provide input and get information, however, without having a vote when it comes to decisions. In pre-seed or seed rounds, it is not uncommon for the company not to have established an advisory board (*Beirat*) yet. In such cases, the reserved matters that would otherwise fall within the competence of the advisory board typically remain subject to approval by the shareholders' meeting.

Majorities: Investors will always consider the majority situation to pass as well as to hinder (veto) certain decisions and may seek specific voting rights that allow them to have a say in critical company decisions, whether taken at the shareholders' or at the board level.

At the shareholders' level, these decisions are typically listed in the articles of the company, and special majority requirements could be tied to a certain shareholding percentage or majorities among specific classes of shares, such as preferred shares (i.e., shares acquired by investors in a financing round).

At the board level, the rules of procedure for the management typically list those management matters that require board approval, including – in many cases – the affirmative vote of board members delegated by certain investors (which effectively means a veto right on such measures). Depending on the number of board members delegated by investors and the overall size of the board, investors can also exert direct influence on passing certain business decisions.

5. Drag-along, other exit rights and share transfer restrictions

Drag-along rights allow a defined majority of shareholders (in early stages usually in a range of 75% or more) to compel all remaining shareholders – including the founders – to sell their shares to a third-party acquirer on the same terms and conditions. The purpose of a drag-along right is to enable a clean exit by ensuring that no minority shareholder can block the sale of the entire company.

In addition to drag-along rights, shareholders typically negotiate **co-sale or tag-along rights** (*Mitveräußerungsrecht*), which entitle them to participate in a share transfer initiated by other shareholders on the same terms and conditions.

Share transfer restrictions are provisions that limit the ability of shareholders to freely transfer their shares. The most common restriction is a **right of first refusal** (*Vorerwerbsrecht*), under which existing shareholders have the right to acquire shares on the same terms offered by a third-party buyer before such transfer can be completed. In addition, share transfers are often subject to the prior consent of the shareholders' meeting. Lock-up periods, during which founders are prohibited from transferring any shares, are also common and typically aligned with the vesting period. Founders should ensure that customary exceptions (e.g., transfers to founder holding vehicles or among co-founders) are carved out from these restrictions.

In the early stages, there is typically not too much to negotiate here.

6. Representations and warranties

Representations and warranties are statements of fact (i.e., statements on status quo or on the past – never statements predicting the future) relating to the company and its business which the company – and in early stages also the founders – guarantee to be true. These statements cover matters like due incorporation and share ownership (so-called **title warranties**), the company's financials, intellectual property, compliance with laws, and the absence of legal disputes (so-called **operational warranties**). If any of these representations and warranties turn out to be false and such circumstances have not been disclosed to the investor before signing, the investor may have the right to seek compensation or other remedies.

The liability of the company and the founders is typically subject to a **liability cap**, i.e., a contractual limit on the amount of damage the company or founders may be required to pay if there's a breach of a representation or warranty. The company's liability cap usually limits the liability to the total investment amount or a portion thereof. The founder's (or founder vehicle's) liability cap is usually based on the founder's annual salary.

7. Founder vesting

Founder vesting is a mechanism that ties the ownership of a founder's shares to their active involvement in the company's business operations. It refers to the gradual (re-)acquisition of full ownership rights over time. Until shares are fully vested, if a founder leaves the company, the vested and/or unvested portion is subject to a call-option and can be repurchased by the company or its other shareholders against a pre-defined compensation. The **number of shares that can be repurchased**, as well as the amount of **compensation** to be paid to the leaver, usually depend on the circumstances under which a founder leaves (so-called **good leaver** and **bad leaver** scenarios).

Vesting periods generally have a duration of between 36 and up to 60 months during which shares vest monthly or quarterly. Sometimes, during the first year of the vesting period, no shares vest, and after the lapse of the first year, a respective pro-rata portion (e.g., 25 %, depending on the overall vesting period) vests at once (so-called cliff period).

8. Preparation of the legal documentation

The lead investor and the founders usually align on whether the investor's legal counsel or the company's legal counsel prepares the first draft of the long form agreements (i.e., the investment agreement, shareholders' agreement, and their annexes), which will serve as the basis for final negotiations. From the company's perspective, it is generally advantageous to be in the lead on the initial draft, as it allows the founders to set the baseline for negotiations and shape the structure and tone of the documentation in their favor. Conversely, where the investor's counsel prepares the first draft, any amendment sought by the company effectively becomes an uphill battle, as the burden of justifying deviations from the existing text shifts to the founders.

9. Exclusivity

Exclusivity typically refers to a commitment by the startup to negotiate solely with a specific investor or group of investors for a certain period (exclusivity in negotiation). This is the more common type of exclusivity in practice and is generally considered market standard in VC term sheets.

Another type of exclusivity is a so-called closing exclusivity, i.e., the obligation of a startup not to close a funding round with someone else for a certain period of time.

If agreed, the exclusivity clause is one of the few binding clauses in the VC term sheet. Founders should be cautious not to grant exclusivity for more than four (4) weeks, as longer periods may unnecessarily restrict the company's ability to pursue alternative financing options and weaken its negotiating position.

10. Cost cover

Cost cover refers to the agreement that the startup will reimburse certain expenses incurred by the investor(s) during the transaction process (e.g., the due diligence and the negotiations). Typically, the cost cover includes legal fees and fees of other external advisers.

The parties often agree that the cost cover is capped at a certain amount.

Another important question is whether the cost cover is one of the few binding clauses in the VC term sheet that also comes into effect if the transaction is aborted, or whether such cost cover only applies if the funding round with this investor is successful. In early-stage financing rounds, founders should avoid agreeing to a binding cost-cover obligation that applies regardless of whether the transaction is consummated. Such provisions are generally considered off-market at this stage and may expose the company to significant and unjustified costs in the event of an aborted transaction.

3. Other important topics

a. Cooperations with corporates

Startups enter into cooperations with established corporates for a variety of reasons and objectives, e.g., in order to

- → gain know-how and development resources,
- → get access to data,
- → pilot and validate products or technologies in a real-world environment,
- → explore distribution and sales channels,
- → secure customer and market access,
- → obtain funding,
- → ...

Such cooperations can be a valuable tool for startups. At the same time, founders may face a number of challenges when negotiating, implementing, and managing such arrangements. The following section outlines key types of cooperation agreements, highlights typical challenges and pitfalls, and provides an overview of contractual mechanisms to address them.

I. SELECTED MAJOR TYPES OF COOPERATION AGREEMENTS

By their nature, cooperation agreements are highly case-specific, which makes standardization difficult. Key types of cooperation agreements relevant for (early-stage) startups include:

IP / DEVELOPMENT COOPERATIONS

Under these arrangements, startups collaborate with corporates to develop a prototype, pilot project or specific IP. The corporate typically contributes know-how, development capabilities, access to facilities (e.g., manufacturing sites or labs), funding, or a combination thereof.

In return, the corporate will usually seek certain rights in relation to the developed product, such as licenses to IP, distribution rights or rights to offer services based on the product (e.g., integration of software components into existing solutions).

SALES AND DISTRIBUTION COOPERATIONS

Startups may also leverage existing sales and distribution channels of established corporates to accelerate market access. The corporate's involvement can range from generating or forwarding leads to actively acting as an intermediary between the startup and end customers.

In return, the corporate typically receives remuneration, often structured as a percentage of revenues generated through its involvement. A key negotiation point in this context is the scope and duration of such remuneration.

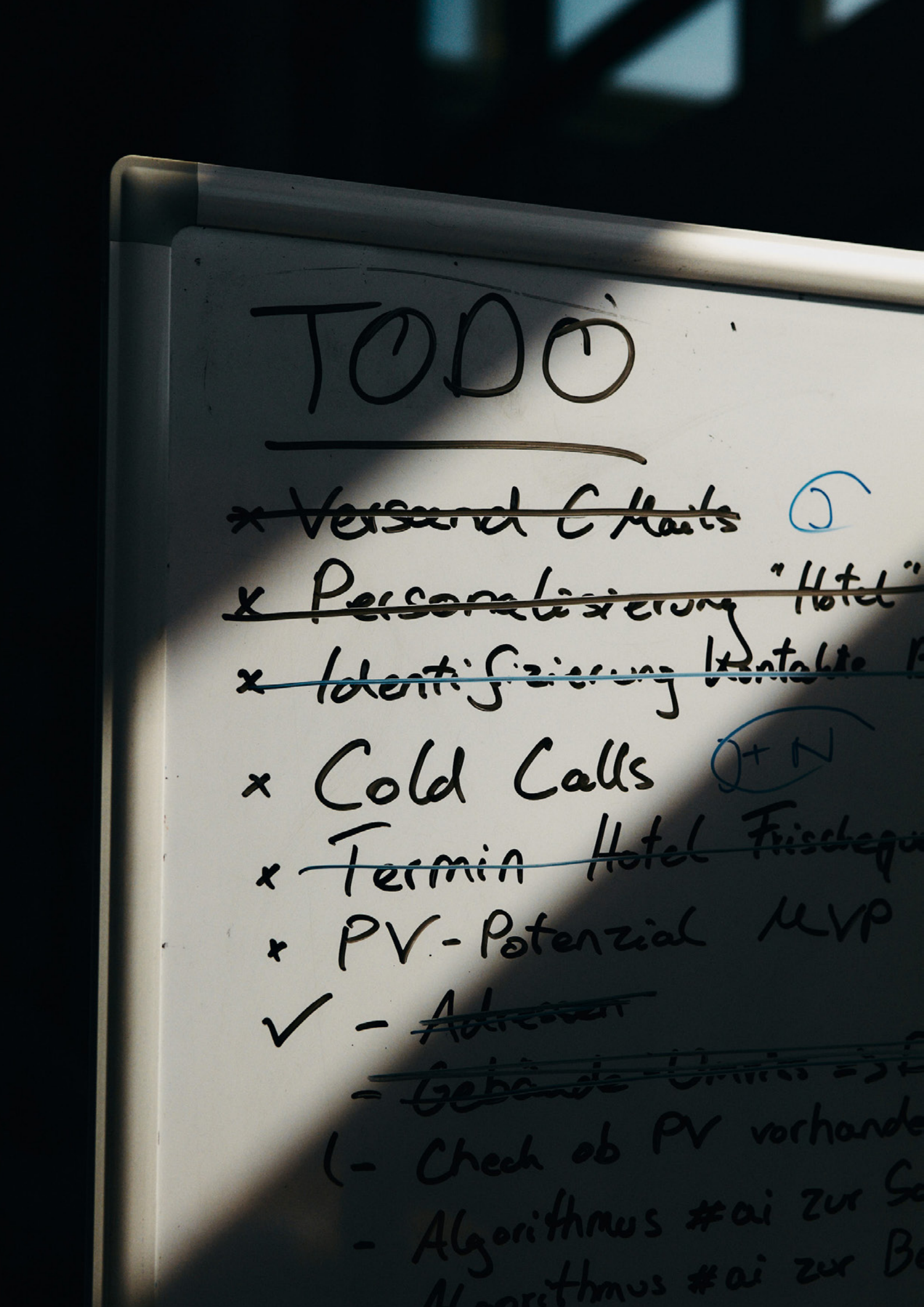
Example: A corporate generates leads for the startup, while the startup concludes the contracts with the referred customers. From the corporate's perspective, its limited involvement in the closing and ongoing customer relationship creates a risk of being bypassed. This is typically addressed through contractual provisions granting the corporate a share in revenues generated with such customers over a defined period (which may extend over several years). Conversely, the startup will seek to limit both the scope and duration of such participation. If not carefully negotiated, this can become a significant commercial burden.

FUNDING / CVC PARTICIPATION

Another form of cooperation is a genuine equity investment by a corporate VC investor in the startup through which the startup may benefit from access to the corporate's know-how, markets, networks, customers, etc.

As already described in section 2 b) iv), this form of cooperation has its very own challenges. VC-financed startups (or startups intending to raise VC money) should always comply with the "venture capital rules of play" and avoid granting "strategic rights" to the corporate VC investor.

For further considerations on this type of cooperation, please refer to section 2 b) iv)


TODO
x Versand E-Mails
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II. KEY CHALLENGES AND PITFALLS

Two main areas of challenge are the process, as well as certain contractual provisions governing the cooperation.

PROCESS

The process of negotiating and implementing a cooperation with an established corporate may differ significantly from the process of a VC financing round both, in speed and parties involved.

Founders should be aware that, as a rule of thumb, bigger organizations tend to move more slowly than startups and VC investors. It is therefore vital to define an agile, and cost-efficient process early on and follow it. Important questions in this context are:

Who needs to be involved, and who is responsible for decisions?

Cooperation agreements typically require input from various departments on both sides, such as operations, product, and finance. It is important to identify early on who needs to be involved, what information they require, and – crucially – who has decision-making authority. The competencies and responsibilities on the corporate's side may not be obvious, and founders should not hesitate to ask whether the right people are at the table. Bigger organizations may also have complex internal compliance or approval procedures that take time to complete; understanding these early helps avoid delays and unnecessary costs. Finally, founders should confirm that authorized representatives of the corporate are available on the proposed signing date or have issued a respective power of attorney to an available attorney-in-fact.

Failing to secure commitment from all relevant stakeholders within the respective organization is one of the most common and costly mistakes early-stage startups make when pursuing a cooperation.

What is the envisaged timeline?

The parties should define and agree on a detailed timeline from the signing of the term sheet to the execution of the cooperation agreement, including specific dates for delivering drafts, providing mark-ups, scheduling negotiation calls, and final sign-off. A clear timeline disciplines all parties and allows the startup to hold the corporate accountable for delays.

Who is in charge of drafting the agreements and when?

Before investing in fully-fledged legal documentation, the parties should first develop a joint commercial understanding of the cooperation and record it in a (typically non-binding) term sheet. The term sheet should address not only commercial terms but also process matters, including who drafts the agreements and when. Letting the corporate side provide the first draft may reduce costs (since cooperation agreements are typically tailor-made and costly to draft), but negotiating against a first draft prepared by the other side can be an uphill battle. Having all key understandings in writing allows founders to hold the other side accountable.

SELECTED CONTRACTUAL PROVISIONS

Please see below a selection of typical contractual provisions that may be found in certain types of cooperation agreements.

Scope of cooperation and respective limitations

The agreement should clearly define the purpose and scope of the cooperation, including the activities each party is expected to perform and respective responsibilities. Equally important are limitations, i.e., what is not part of the project or excluded from a party's responsibilities. Clearly defining the scope helps manage expectations and reduces the risk of failure or even disputes about additional work or responsibilities.

Dealing with uncertainties

Pilot and development projects often involve technical, commercial, or operational uncertainties. Agreements should therefore address how such uncertainties and cost increases are handled, for example, through flexible milestones, review mechanisms, or procedures for adapting the project and budgets if assumptions prove incorrect. This ensures that both parties can react pragmatically if the project evolves differently than initially expected.

Deliverables (if any) – works or services

If the cooperation involves concrete outcomes, the contract should specify the deliverables. This may include defined works (e.g., a prototype, software module, or report) or services (e.g., testing, integration support, or consulting). An important distinction in this context is whether a party owes a specific work result (Werkvertrag) or merely the diligent performance of its services (Dienstvertrag), as this determines, among other things, whether the obligor bears the risk of achieving the agreed outcome. Clear descriptions of deliverables, timelines, and acceptance procedures help avoid misunderstandings about whether obligations have been fulfilled.

IP – background vs. foreground IP

Oftentimes, a key issue in cooperation among startups and corporates is the distinction between background IP (intellectual property owned by a party prior to the cooperation) and foreground IP (IP created during the cooperation). Agreements should clearly state that each party retains ownership of its background IP and specify who owns any foreground IP generated through the cooperation.

IP – licensing scope, terms and limitations

Where one party needs access to the other party's IP for the purpose of the cooperation, the contract should clearly define the scope of the license granted. Important aspects include the permitted use, duration, territorial scope, exclusivity, and whether sublicensing is allowed. For startups in particular, it is important to ensure that licensing arrangements do not unintentionally restrict the future commercialization of their product.

Confidentiality

Cooperations frequently involve the exchange of sensitive information, whether technical, financial, or commercial. Confidentiality provisions regulate how such information may be used, protected, and disclosed. They typically define what constitutes confidential information, how long confidentiality obligations apply, and in which limited situations disclosure may be permitted. Further provisions include the return and/or deletion of confidential information and the respective limitations (typically for bona fide data-backup systems that are inaccessible in the ordinary course of business).

Exclusivity

Corporates may also request exclusivity provisions, e.g., in case of a sales/distribution cooperation with regard to a certain territory, or customer base or in the form of restrictions as regards cooperations with competitors of the corporate for a defined period or within a specific field. Founders should carefully assess the scope and duration of such clauses, as broad exclusivity obligations may significantly restrict business opportunities and might be (red-)flagged by investors in future due diligence (or require approval of existing investors).

Non-solicitation

Non-solicitation clauses prevent one party from actively recruiting or hiring employees of the other party, or from approaching customers of the other party, during the term of the cooperation and for a defined period thereafter. Such provisions aim to protect both parties' teams and prevent talent or customer poaching during close collaboration.

Compliance with laws and corporate-internal policies

Corporates often require contractual assurances that the startup complies with applicable laws and certain internal policies (e.g., anti-corruption, data protection, export control, or sustainability standards). Startups should review these requirements carefully to ensure they are practical and realistically implementable. Breaches of these clauses may result in extraordinary termination rights.

Term and termination

The agreement should specify the duration of the cooperation and the circumstances under which it may be terminated. Typical provisions include termination for cause, termination for convenience with notice, and automatic termination upon completion of the pilot. The contract should also address what happens after termination, including data handling, IP rights, and ongoing obligations.

III. KEY TAKEAWAYS

Cooperating with a renowned corporate can be of great value in developing and expanding a startup's business if the challenges and pitfalls that come along with it can be resolved.

Ensure that decision-makers on both sides are identified and involved early in the process.

Developing and summarizing a joint commercial understanding with the respective other party early on is key to an efficient process.

Safeguard IP ownership and avoid contractual restrictions (e.g., broad exclusivity) that may limit future business opportunities.

The requirements of (future) venture capital must be understood and kept in mind when entering strategic cooperations.

b. Employment law 101

Employment law and its relevance for early-stage startups are often underestimated by founders. German employment law is notably employee-friendly and, compared to many other jurisdictions, places significant obligations on employers even from the moment of the first hire. Getting it wrong – whether through non-compliance with formal requirements, poorly drafted agreements, or misclassification of factual employees as freelancers – can result in substantial financial liability, reputational damage, and operational disruptions. Furthermore, the rules of employment court proceedings provide for several special provisions making it easy (and cheap) for employees to sue their (former) employer, which is why it is a quite litigious field.

This section provides founders with a practical overview of selected key employment law considerations they need to understand as they begin building their teams.

DOs

Do sign employment agreements by hand – always

While German mandatory law does not per se require an employment agreement to be hand-signed for its validity, certain clauses (e.g., non-compete obligations and timely limitations) do. Breaches of this requirement result in the respective clause not being valid, e.g., time limitations agreed by simple electronic signature are invalid, and the respective employment agreement is concluded without any limitation in time.

Furthermore, the evidence of Employment Terms Act (*Nachweisgesetz*) requires employers to document the essential terms of the employment relationship in writing (i.e., wet-ink signature) and provide this to the employee. Violations of this requirement may result in fines of up to EUR 2'000 per breach.

It is therefore best practice to generally sign employment agreements by hand to avoid mistakes.

Do be mindful of the threshold for general dismissal protection

The "*Kündigungsschutzgesetz*" applies to employees who have been employed for more than six months in a business with more than ten employees (full-time equivalents, so-called FTEs). Once this threshold is crossed, dismissals must be justified by reasons relating to the person, the employee's conduct, or urgent operational requirements (*sozial gerechtfertigt*). This dramatically increases the complexity and risk of ending an employment relationship. Founders should be aware that crossing the ten FTE threshold is a significant legal milestone that requires a more structured HR approach.

Do consider confidentiality and IP assignment clauses carefully.

Employment agreements for startup employees should contain robust provisions on confidentiality and, particularly for technical developers, the assignment of intellectual property created in the course of employment. Under German law, IP created by an employee in the course of their duties generally vests in the employer. However, to avoid uncertainties (e.g., for IP created partly outside of working hours or at the margins of the employee's role), a clear contractual clause is strongly advisable. In

addition, founders should be aware of the German Employee Inventions Act (*Arbeitnehmererfindungsgesetz – ArbNErfG*), which applies to patentable inventions and technical improvement proposals made by employees. Even where the employer is entitled to claim a service invention (*Diensterfindung*), the employee retains a statutory right to reasonable compensation (*angemessene Vergütung*) which cannot be waived in advance. Failure to comply with the procedural requirements of the ArbNErfG (e.g., timely claiming of the invention) may result in the invention rights reverting to the employee.

Do seek legal advice before introducing post-contractual non-compete clauses

Post-contractual non-compete clauses (*nachvertragliche Wettbewerbsverbote*) for employees are permissible but are only legally binding if the employer commits to compensate the employee by payment of at least 50% of their last contractual remuneration (*Karenzentschädigung*) for the duration of the restriction (with other income of the employee during the period being credited against the compensation payment, i.e., effectively reducing the compensation). Non-competes that do not meet this requirement are void and non-binding, meaning the employee is free to join a competitor, and the clause provides no protection whatsoever. Also permissible is a waiver option for the company regarding post-contractual non-compete clauses, allowing it to opt out and avoid the compensation payment.

Do respect mandatory minimum standards

German employment law includes several mandatory provisions (*zwingende Vorschriften*) that cannot be opted out of, even with the employee's consent. These provisions include (i) the statutory minimum wage (*Mindestlohn*), (ii) minimum paid annual leave entitlement of 20 days in case of a five-day week, (iii) continued remuneration during illness for up to six weeks, (iv) certain protections for pregnant employees and parents, and (v) the working time regulations under the Working Time Act (Arbeitszeitgesetz – ArbZG), which impose a maximum regular working time of eight hours per working day (extendable to ten hours subject to compensation within a reference period), mandatory rest periods of at least eleven hours between working days, and restrictions on work on Sundays and public holidays. Founders should be particularly mindful of these working time limits, as violations may result in administrative fines and, in serious cases, criminal liability.

Do understand the rules on fixed-term employment contracts (*Befristungen*)

Fixed-term employment contracts are a common and often attractive tool for early-stage startups, but they are subject to strict formal and substantive requirements under the Part-Time and Fixed-Term Employment Act (*Teilzeit- und Befristungsgesetz – TzBfG*). First, any fixed-term clause must be agreed in writing (*Schriftform*, i.e., wet-ink signature) before the employment commences. If the written form requirement is not met, the fixed-term clause is void, and the employment is deemed to have been concluded for an indefinite term. Second, a fixed-term contract generally requires an objective justifying reason (*Sachgrund*), such as a temporary operational need, a project-based assignment, or the replacement of another employee. Without such a reason, a fixed-term contract is only permissible under the statutory exception for fixed-term employment without objective justification (*sachgrundlose Befristung*), which allows for a maximum duration of two years with up to three extensions within that period, provided the employee has not previously been employed by the same employer. Importantly, for newly founded companies (*Neugründungen*), the legislator has introduced a significant relaxation: pursuant to sec. 14 (2a) TzBfG, fixed-term contracts without objective justification may be concluded for a period of up to four years (with multiple extensions permitted within that period) during the first four years following the establishment of the company. This privilege does not apply to startups that result from a legal restructuring of an existing company. Founders should be aware of these rules from the outset, as non-compliance – in particular with the written form requirement – will result in the unintended creation of permanent employment relationships.

DON'Ts

Don't issue verbal, electronic or loosely worded terminations

Dismissals must be in written form, i.e., a hand-written or printed letter signed in wet-ink, to be valid. Electronic communications (e-mail, WhatsApp, fax, etc.) do not satisfy the written form requirement and result in the dismissal being null and void. The employee retains all rights as if the dismissal had never occurred. Founders must ensure that any termination is issued correctly, on time (in accordance with notice periods), and – where the KSchG applies – for a legally sufficient reason.

Practical relevance: a termination during the probationary period (*Probezeit*) via e-mail. In these cases, a "clever" employee could not show up for the rest of the probationary period and reappear for work on the day following the probationary period. From this day, notice periods for terminations are longer and (if the startup has more than 10 FTEs) general dismissal protection (*Kündigungsschutzgesetz*) applies, making it more difficult for the employer to terminate the employment relationship. Typically, these cases end by settlement, which includes a respective settlement payment by the employer – money that is better spent on the development of the company.

Don't overlook special protection against dismissal for certain groups.

Even before the general dismissal protection threshold (10 FTEs) is reached, certain categories of employees enjoy special statutory protection against dismissal that applies regardless of company size, e.g.: (i) pregnant employees and those on maternity leave (*Mutterschutz*), Employees on parental leave (*Elternzeit*), severely disabled employees (*Schwerbehinderte*).

Don't misclassify employees as freelancers – the risk of mock self-employment (*Scheinselbstständigkeit*) is severe

German social security authorities (*Deutsche Rentenversicherung*) and tax authorities look at the substance of the working relationship, not its label. Indicators of genuine freelance status include: (i) working for multiple clients, (ii) bearing entrepreneurial risk, (iii) providing one's own equipment, and (iv) not being integrated into the client's organisation. If a person works exclusively or predominantly for one startup, follows its instructions, uses its equipment, and works regular hours set by the startup, they are likely an employee in the eyes of the law regardless of what the freelance agreement says. The consequences of misclassification are severe.

The startup can be held liable for up to four years of unpaid social security contributions (up to 30 years in cases of intentional evasion), plus penalties and interest.

Don't inadvertently engage in unlicensed temporary agency work (*Arbeitnehmerüberlassung*)

Startups occasionally deploy their own personnel at a client's or cooperation partner's premises or, conversely, engage workers through third-party service providers who are then integrated into the startup's own organization. In either scenario, founders must be mindful of the Temporary Agency Work Act (*Arbeitnehmerüberlassungsgesetz – AÜG*). The commercial lending of employees to third parties requires a permit (*Erlaubnis*) from the Federal Employment Agency. Whether a particular arrangement constitutes temporary agency work depends on substance, not on the label of the underlying agreement: if the receiving entity exercises the right to direct and supervise the deployed workers (*Weisungsrecht*) and integrates them into its own organisational structure, this will typically qualify as temporary agency work irrespective of whether the parties have characterised the arrangement as a service or work contract. The consequences of unlicensed temporary agency work are severe: the employment relationship with the lending entity is deemed void and an employment relationship with the borrowing entity is deemed to exist by operation of law. In addition, administrative fines of up to EUR 30,000 per violation may be imposed. Founders should therefore carefully assess any arrangements involving the deployment of personnel across company boundaries – whether inbound or outbound – and seek legal advice where the classification is unclear.

Don't rely on a "standard" or online contract template without customization

Generic employment contract templates found online may not reflect mandatory German law requirements and relevant court rulings (which are issued quite frequently), may contain clauses that are void under German standard terms control (*AGB-Kontrolle*), or may fail to address matters critical to the specific startup's requirements. A poorly drafted contract is often worse than no contract at all – void clauses are typically simply struck out, which may leave the employer in a worse position than the statutory default. Properly drafted employment agreement template(s) are a good and not too costly investment from the start.

iii. Checklist for hiring (and terminating) employees

The following is a non-conclusive checklist for important actions and measures when hiring or dismissing employees, as well as certain ongoing items to be aware of.

This checklist does not replace obtaining legal counsel when required in individual cases.

Hiring – before the first day

1. Draft and execute a written and wet-ink signed employment contract meeting statutory minimum requirements
- covering all *Nachweisgesetz* required items (in particular start date, job title and description, place of work, remuneration, working hours, notice periods, holiday entitlement, applicable collective agreements if any);
- incl. confidentiality clauses and clauses on the return of company property and data upon termination;
- incl. where relevant IP assignment clauses and (post-contractual) non-compete clauses.

2. Obtain the employee's social security number (*Sozialversicherungsausweis*), tax identification number (*Steuer-ID*), and health insurance provider details.

3. Register the company as an employer with the relevant institutions if not already done:
- *Betriebsnummer* with the Federal Employment Agency (*Bundesagentur für Arbeit*)
- Registration with the relevant health insurance fund (*Krankenkasse*)
- Registration with the relevant employers' liability insurance association (*Berufsgenossenschaft*)

4. Set up payroll processing (in-house or via payroll service provider) to ensure correct calculation and timely payment of wages and social contributions

- [ ] **5.** Ensure the employee is informed about applicable data protection rules regarding their personal data (GDPR / DSGVO compliance)
- [ ] **6.** Provide any required safety briefings and workplace instructions under the *Arbeitssicherheitsgesetz*

Hiring – on or shortly after the first day

- [ ] **7.** Provide the signed employment contract to the employee (on day one for *Nachweisgesetz* compliance)
- [ ] **8.** Introduce the employee to applicable workplace policies (IT usage, data protection, code of conduct, expense policy, etc.) and consider having these acknowledged in writing
- [ ] **9.** Ensure the employee is aware of their working time obligations and record-keeping requirements

Ongoing

- [ ] **10.** Maintain accurate records of working hours (mandatory requirement)
- [ ] **11.** Process payroll accurately and on time each month; provide payslips (*Lohnabrechnung*)
- [ ] **12.** Remit wage tax (*Lohnsteuer*) and social security contributions (*Sozialversicherungsbeiträge*) to the relevant authorities monthly
- [ ] **13.** Track holiday entitlement and ensure employees take their statutory leave

14. Monitor headcount relative to legal thresholds (10 employees for *Kündigungsschutzgesetz*) ◯

Termination / Offboarding – before issuing notice

15. Consider whether a termination agreement (*Aufhebungsvertrag*) is preferable to a unilateral dismissal. Mutual agreements avoid litigation risk but must be carefully structured (employees who sign a termination agreement may face a temporary suspension of unemployment benefits from the *Bundesagentur für Arbeit*) ◯

16. Confirm the applicable notice period (statutory under §622 BGB or contractual, whichever is longer) ◯

17. Check whether the *Kündigungsschutzgesetz* applies (employment > six months; > ten employees). If so, ensure a legally sufficient ground exists: personal reasons (*personenbedingt*), conduct-related reasons (*verhaltensbedingt*), or operational reasons (*betriebsbedingt*) ◯

18. Check for special dismissal protection (pregnancy, parental leave, severe disability, etc.) since prior authority approval may be required ◯

19. If dismissal is for conduct-related reasons, consider whether a prior written warning (*Abmahnung*) is required (generally yes, for most conduct-related dismissals) ◯

20. If operational reasons are cited and multiple employees are comparable, conduct a proper social selection (*Sozialauswahl*) considering seniority, age, maintenance obligations, and disability status ◯

21. Prepare the termination declaration/dismissal letter in proper written form (wet-ink signed original) ◯

22. Plan for secure delivery of the dismissal letter (ideally in person with a witness – standard postal delivery is risky since proof of receipt is difficult)

Termination / Offboarding – upon and after issuing notice

23. Issue the termination letter and keep a copy

24. Confirm in writing the agreed end date of the employment relationship

25. Address any garden leave (*Freistellung*) arrangements clearly in writing

26. Arrange for the return of all company property (laptop, access cards, mobile devices, etc.)

27. Revoke access to company systems, email, and data (coordinate with IT)

28. Calculate and pay out any outstanding remuneration, pro-rata holiday pay for accrued but untaken leave, and any other outstanding entitlements

29. Issue a reference letter (*Arbeitszeugnis*) upon request. Employees have a legal right to a reference, and to a qualified reference covering performance and conduct (*qualifiziertes Arbeitszeugnis*) if requested. Importantly, the reference letter must be written in a benevolent (*wohlwollend*) but truthful manner since German courts have developed extensive case law on the coded language of reference letters

30. File final payroll and deregister the employee from Social Security upon termination

IV. APPROACH TO EMPLOYMENT LAW IN EARLY STAGES

Employment law in Germany rewards preparation and punishes improvisation. The best time to get the basics right is before the first hire, not after the first dispute arises. Properly drafted employment agreement template(s) and a basic HR policy framework, or a workshop by skilled employment law specialists at the earliest possible stage, are a good investment. The cost of prevention is a fraction of the cost of a labor court dispute, and the reputational and operational damage of a dismissal gone wrong in a small, close-knit team can far exceed the legal fees.

c. Employee participation 101

Practically every early-stage founder has heard of employee participation – mostly under the terms ESOP or VSOP – yet mentors and legal counsel often have severe misunderstandings and rather superficial level of knowledge. The idea of employee participation is compelling: if your team participates in the economic success of an exit, they will be more motivated, more loyal, and more aligned with the long-term success of the business.

Used correctly, equity-based participation is a powerful tool to attract and retain talent that start-ups could otherwise not afford. Used incorrectly, it may result in detrimental tax traps and disappointed employees.

In today's competitive talent market, employee participation is not a nice-to-have – it is the price of admission for attracting the best people.

This section provides a practical overview of why employee participation matters, the key challenges in a German legal context, how to think about the distinction between broad-based employee participation and participation by management members or late co-founders, and a brief comparison of the characteristics of selected major models.

I. REASONS AND OBJECTIVES FOR EMPLOYEE PARTICIPATION

ATTRACTING TALENT IN A COMPETITIVE MARKET

Early-stage startups typically cannot match the salaries offered by established technology companies, consultancies, or banks. Employee participation, i.e., the promise of a share in the value that the team creates together, is the primary mechanism by which startups compensate lower salaries.

RETENTION AND ALIGNMENT OF INCENTIVES

Participation programs are typically structured with vesting schedules, i.e., provisions pursuant to which the participation instruments allocated to an employee are typically earned gradually over time, conditional on continued employment, and thereby create a retention mechanism.

A standard vesting schedule in the German startup market has a total vesting period of four years, with a one-year cliff (meaning nothing vests for the first twelve months, after which 25% vests at once, and the remainder vests monthly or quarterly thereafter). However, more backloaded vesting schedules are becoming more common.

CULTURE AND OWNERSHIP MENTALITY

Beyond the financial mechanics, a participation program sends a cultural signal. It tells employees that they are (at least) economically treated as co-owners, not just contributors. This “ownership mentality”, i.e., a willingness to go beyond the strict boundaries of one’s job description, to flag problems proactively, and to care about the company’s performance, is particularly valuable in the early stage, when the team is small, and everyone’s contribution is visible and consequential.

INVESTOR EXPECTATIONS

Institutional investors expect to see a functioning employee participation program in place or a willingness to create such a program in the context of their investment.

II. KEY CHALLENGES OF EMPLOYEE PARTICIPATION

TAX

One of the most central considerations for every employee participation program is its tax effects for the company and the beneficiary. All forms of employee participation must prevent the notorious "dry income" problem, i.e., a scenario in which the allocation or subscription of participation instruments results in a non-cash benefit (*geldwerter Vorteil*) that is subject to taxation at the time of allocation or subscription.

Different models achieve this objective in different ways:

- The historically most common and still predominant form of employee participation in Germany – the VSOP or virtual share option program, or sometimes also called phantom shares – does not lead to a non-cash benefit at the time of allocation.
- Participation programs based on real shares or profit participation rights are eligible to make use of a tax deferral provision – the often quoted sec. 19a German Income Tax Act (*Einkommensteuergesetz*) – which, subject to certain prerequisites, essentially allows for a deferral of taxation of the non-cash benefit (*geldwerter Vorteil*) until the beneficiary has received liquid funds to pay the tax.

CORPORATE GOVERNANCE

From a startup and shareholder perspective, genuine employee participation programs (for management or late co-founder participation, please see below) must not convey certain governance rights available to shareholders, such as extensive information rights or participation rights in shareholders' meetings.

REASONABLE ADMINISTRATIVE EFFORTS AND COSTS

Employee participation programs must be manageable for the company in its current stage and come at a reasonable setup (and potentially also ongoing) costs. While virtual programs are easy to handle, even for small organizations, equity or equity-like based programs require higher administrative efforts in implementation and ongoing allocations/subscriptions and typically result in higher one-time and ongoing costs.

FAIR AND APPROPRIATE

To motivate employees, programs must balance the partly diverging interests of employees, the company, and its shareholders. The most striking example of this is vesting and leaver provisions. The company's interest in employee retention and the employee's interest in fair leaver provisions must be balanced accordingly.

These provisions are also the subject of various court rulings. As a recent and by now quite famous ruling, the Federal Labor Court (BAG) decided that provisions on the forfeiture of vested instruments upon resignation by the employee (as a so-called bad leaver) are invalid if the vesting of instruments has traits of wage. At least prior to this ruling, treating the ordinary termination of the beneficiary as a bad leaver event was well within the range of market practice, which has since adapted several alternative provisions as an alternative to achieve at least commercially comparable results.

FLEXIBILITY

Given that employee participation programs are typically mainly exit-triggered and thus have rather long terms, the company requires a certain flexibility to redesign such programs, e.g., due to changes in law or new court rulings or in the context of corporate restructurings, such as a change of legal form into a stock corporation. This can be achieved by respective provisions allowing for redesigns that are not economically detrimental for beneficiaries.

III. EMPLOYEE VS. MANAGEMENT/LATE CO-FOUNDER PARTICIPATION

An important lesson for founders is that broad-based employee participation and the participation of management members or late co-founders are not the same thing and require different ways of thinking about them.

In essence,

- **broad-based employee participation** is the grant of small economic stakes (as a rule of thumb significantly <1 % of the fully-diluted share capital) to a larger group of employees, often times structured as virtual instruments (VSOPs/phantom shares) or, particularly in later stages, profit participation rights (*Genussrechte*) to avoid the legal implications, administrative efforts and potential tax complications of real share transfers; alternatively, broad-based employee participation may be structured through a separate employee participation entity (e.g., a dedicated partnership vehicle) that pools the economic interests of the beneficiaries, although this approach requires additional structuring efforts and careful legal and tax planning;
- **Management and late co-founder participation** is the grant of meaningful economic stakes to key individuals (heads of department, C-suite members, or genuine late co-founders) who are expected to take on founder-like responsibilities, have "skin in the game", and are in a position to request respective compensation. Major participation models for these individuals include real shares in the company (structured tax efficiently) and profit participation rights (*Genussrechte*).

The main reasons real shares in the company are generally not a suitable instrument for broad-based employee participation are:

- The transfer of real shares in the GmbH requires notarization, which produces inappropriate costs and requires administrative efforts.
- Real shares convey certain indefeasible rights to their holders, such as information rights and certain participation rights in shareholders' meetings, which are considered too extensive for the broader group of employee beneficiaries.

IV. OVERVIEW ON SELECTED MODELS OF EMPLOYEE PARTICIPATION

	Employee Participation	
	Virtual participation (VSOP)	**Profit participation rights (*Genussrechte*)**
Explanation	Non-corporate participation, i.e. legal status of the beneficiary as if he/she were a shareholder, entitlement to (cash) payments on exit	Non-corporate but "Equity-like" participation in a company; similar to VSOP
Typical area of application	Participation of a larger number of beneficiaries, especially in earlier stages	Participation of a larger number of beneficiaries
Taxation upon granting	none	deferred
Taxation on exit	Taxable salary (up to approx. 47.5 %)	Value at grant taxable salary (up to approx 47.5 %) & Increase in value since grant: capital gains (approx. 26.4 % to 28.5 %)
Information and corporate participation right	basically none	basically none
Implementation effort and costs	Comparably low	Medium (early-mover costs since no real standard, yet; obtaining a tax ruling acc. sec. 19a para.(5) recommended)

Management Participation

Hurdle Shares	Direct participation with "19a shares"
Granting of shares with a so-called negative liquidation preference	Granting of shares with deferred taxation (not to be held through a corporate holding entity, e.g. UG)
(Further) incentivisation of founders & Incentivizing an additional (later) founder team member or successor	(Further) incentivisation of founders & Incentivizing an additional (later) founder team member or successor
none (to the extent the shares are valued at EUR 0.00 (nil))	deferred
Capital income (approx. 1.5 % since 95 % tax-free if held through a corporate holding entity, e.g. UG)	Value at grant taxable salary (up to approx 47.5 %) & Increase in value since grant: capital gains (approx. 26.4 % to 28.5 %)
Extensive rights as a shareholder, e.g. information and voting rights; restriction of rights in the articles of association, e.g. non-voting shares possible; however, complete exclusion of shareholder rights not permitted	Extensive rights as a shareholder, e.g. information and voting rights; restriction of rights in the articles of association, e.g. non-voting shares possible; however, complete exclusion of shareholder rights not permitted
Medium to high (obtaining a tax ruling highly recommended)	Low to Medium (obtaining a tax ruling acc. sec. 19a para.(5) recommended)

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