German Federal Court of Justice confirms PE and VC equity incentive structures – but sets clear boundaries for vesting provisions

Whether you are a fund sponsor structuring a management incentive plan for a new portfolio compa-ny, a founder negotiating vesting terms with a VC investor, or an in-house counsel reviewing exist-ing equity arrangements – a recent landmark ruling by Germany's Federal Court of Justice (Bun-desgerichtshof – BGH) is essential reading. On 10 February 2026, the BGH's Second Civil Senate issued judgment II ZR 71/24, providing long-awaited clarity on when „free removal clauses" (freie Hinauskündigungsklauseln) – including call option mechanisms in management participation agree-ments – are void under German law, and when they can be justified. The decision is directly relevant to anyone structuring or investing in management incentive plans (MIPs) or employee incentive plans (EIPs) in Germany.

The Background: A PE-Backed Management Equity Structure

A limited partnership ("KG") had been set up to allow managers of a corporate group to participate indirectly as limited partners in the group's operating company ("GmbH") as part of a management equity plan – a structure commonly referred to as „KG pooling", which is the market-standard vehicle for bundling management and employee participations in PE and VC-backed portfolio companies in Germany. Under the management participation agreement, the KG's stake in the GmbH amounted to 1.28% of its share capital. The plaintiff – a managing director of a subsidiary within the company group – joined the KG as a limited partner, paying a contribution of approximately EUR 150,000, equal to the then-current market value of the shares assigned to him, giving him an indirect stake of 0.38% in the GmbH. He had no entitlement to ongoing profit distributions; instead, his participation was limited to exit proceeds upon a sale of the business.

The articles of association of the KG contained a „Call Option" allowing the other shareholders to acquire a departing manager's stake whenever a „Call Event" occurred – including, notably, any situation where the manager (i) ceased to be a managing director or to be in an active service or employment relationship within the company group or (ii) was irrevocably placed on garden leave, for any reason whatsoever. In September 2022, the plaintiff was removed as managing director of the subsidiary without cause by shareholder resolution, his service agreement was terminated by ordinary notice, and he was irrevocably placed on garden leave. The other limited partners of the KG exercised the call option, and the plaintiff received just EUR 35,174 for his stake – a significant loss on his original investment.

The plaintiff argued the call option was void as a „free removal clause" contrary to public policy (sittenwidrig) under section 138 of the German Civil Code (Bürgerliches Gesetzbuch – BGB).

What the BGH Decided

The general rule stands: free removal clauses are void

The BGH reaffirmed its longstanding position that contractual provisions giving a shareholder, a group of shareholders, or the majority the right to expel a fellow shareholder without cause – so-called "free-removal clause" (freie Hinauskündigungsklausel) – are in principle void under section 138 subsection 1 BGB as contrary to public policy (sittenwidrig), unless exceptionally justified by special circumstances.

The rationale is straightforward: an unrestricted right of removal acts as a disciplinary tool. The affected shareholder lives under a constant threat of expulsion – a „sword of

Damocles“ – which may pressure him into aligning with the majority‘s wishes rather than exercising his own rights.

The BGH explicitly rejected calls from academic commentators to replace content control under section 138 BGB with mere exercise control under section 242 BGB. The court‘s reasoning: when the threat works as intended, the affected shareholder gives in to the majority‘s will without ever being formally expelled – meaning no exercise review is ever triggered. Protecting the shareholder‘s freedom to make independent decisions therefore requires upfront content control; reviewing the exercise after the fact is not enough.

When call options in MIP/EIPs are justified

The BGH clarified – and this is the critical practical point – that justification does not require a rigid checklist of criteria to be met cumulatively. Instead, what matters is an overall assessment of all the circumstances of the individual case. The key question is twofold: first, was the stake granted to the manager because of his management role and for a purpose that falls away when that role ends? And second, does the membership interest lack any meaningful independent significance beyond the management role? In answering these questions, the court must consider whether the manager‘s ability to exercise membership rights carried any real weight under the overall structure of the partic-ipation – particularly given the link between the participation and the management position. In the present case, the plaintiff had virtually no ability to enforce his own views as a limited partner of the KG or to influence the management of the operating company (GmbH), in which the KG itself held only a 1.28% stake – leaving the plaintiff with an indirect holding of just 0.38%.

Importantly, the BGH held that two factors do NOT per se prevent justification:

- Exit-only economics: The absence of ongoing profit participation and a sole entitlement to exit proceeds is typical in private equity structures and does not diminish the incentive and retention function of the participation. The BGH likened an exit-proceeds entitlement to a bo-nus for a successful deal close – entirely consistent with PE business models focused on value creation and exit.

- Significant financial risk: The fact that a manager acquires his stake at fair market value – and therefore takes on real investment risk – does not automatically give his stake inde-pendent significance sufficient to defeat the justification of the call option.

The OLG Munich Judgment Was Wrong

The Court of Appeal (OLG Munich) had held the call option void, reasoning that the manager‘s exit-only economics and full economic risk set the case apart from a „conventional“ manager model. The BGH found this reasoning legally flawed and overturned the decision. The case has been remitted to the Court of Appeal for a fresh review – including whether the call option was exercised in good faith (section 242 BGB).

What This Means for Investors, Founders, and Portfolio Companies

The ruling provides practical comfort for MIP/EIP structures, but also a warning: Good news for sponsors and founders: PE and VC-backed structures that tie a manager‘s or employee’s stake to continued employment or service while focusing on exit economics are more likely to survive scrutiny. The BGH has confirmed that market-standard PE management participation structures can be justified even where the manager buys in at fair market value and participates solely in a future exit. This reasoning should, in our view, apply even more where the participant acquires his stake at a discount – as is common in EIPs designed to benefit from the tax deferral under section 19a of the German Income Tax Act (Einkommensteuergesetz – EStG). For investors, this provides welcome legal certainty when rolling out MIP/EIP structures across portfolio companies. For founders, it validates the equity incentive frameworks commonly used to attract and retain key talent.

The BGH clarified that the principles it has developed in relation to “free-removal clauses“ (freie Hinauskündigungsklauseln) are sufficiently flexible to accommodate the objective justification underlying contractual arrangements and to give appropriate weight to evolving economic developments, including the growing prevalence of startup structures. The decision should therefore also be regarded as a significant signal in favour of the validity of standard founder vesting clauses in venture capital agreements – even though the facts of the case, which involved a small, function-linked management participation, are not directly transposable to founder stakes, which typically involve larger holdings that may carry independent significance beyond the founder‘s operational role.

The warning on exercise: The BGH was careful to note that potential abuse – for instance, removing a manager shortly before an exit to deprive him of his upside – can and should

be addressed through exercise control under section 162 subsection 2 or section 242 BGB. A valid call option clause does not confer an unrestricted right of opportunistic exercise.

Call option validity and pricing are assessed separately: The BGH confirmed that the call option clause and the pricing mechanism must be assessed independently of each other. An unfairly low Good Leaver payout does not render the call option itself void – but it may be challenged on its own.

Action Items for Investors, Founders and Portfolio Companies

- Review your MIP/EIP documentation – across your portfolio. If your call option or vesting mechanism permits a manager's removal for any reason without objective criteria, ensure the overall participation package is justifiable under the BGH's holistic test. Investors should consider conducting a structured review of MIP/EIP arrangements across their portfolio companies.
- Anchor the participation to the management role. In the contractual documentation – including recitals – expressly state that the stake is granted because of, and conditional upon, the participant's management or employment role. Retention, alignment of interests and succession planning should be documented as the stated purposes; generic or boilerplate language will not suffice.
- Separate call option and pricing provisions. Draft the call option clause and the Good Leaver / Bad Leaver pricing mechanism as independent, self-standing provisions so that a successful challenge to one does not automatically invalidate the other.
- Guard against bad-faith exercise. Even a valid call option is vulnerable to challenge under German law if exercised opportunistically – in particular where a manager is removed shortly before an exit to deprive him of his upside. Document the grounds for any removal and the timeline leading to exercise.
- Take specialist advice early. Whether designing a new MIP/EIP or triggering a call option under an existing plan, obtain specialist legal advice before acting. The BGH's remittal for an exercise-control review underscores that both the structure and the manner of enforcement are subject to judicial scrutiny.

Whether you are looking to design a new MIP or EIP, to review existing arrangements across your portfolio, or to obtain advice on exercising or defending against a call option – we would be happy to assist. We also offer a targeted MIP/EIP sanity check to assess your current structures against the latest BGH guidance.

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