

Carried Interest and Employment Law

The consideration of Carried Interest in the calculation of severance payments in accordance with Sec. 10 of the German Protection Against Dismissal Act - *Kündigungsschutzgesetz (KSchG)*

This thesis investigates the labour law perspective on Carried Interest, a specific form of profit-share in the Private Equity-sector. Carried Interest has been extensively discussed regarding its tax law aspects, by courts as well as in the legal literature. Yet, labour law issues, arising out of the specific construction of Carried Interest-models have so far only been touched upon marginally in case law and academic research.

The term Carried Interest describes the participation of the managers of Private Equity-funds (referred to in the paper as „*Fonds-Professionals*“) in the funds profits. What differentiates Carried Interest from other concepts of profit sharing, such as royalties or commissions, is the specific structure of the Carried Interest-models. The fund itself is set up as a partnership with the general partner being a Limited (in Germany: *GmbH & Co. KG*). The investors are the limited partners of the fund company. The fund collects the investors' money and acquires majority stakes in several portfolio companies. After a few years, the fund exits from its investments – ideally at a profit – and returns this profit to its investors.

The *Fonds-Professionals* are employed at an employer company, which is only connected to the fund through a consultant contract. At the same time, the *Fonds-Professionals* are shareholders of another company (referred to in the paper as “*Carry Company*”), which itself is a limited partner of the fund. The *Carry Company* receives a percentage of the fund's profits and passes it on to the *Fonds-Professionals* as its shareholders. These amounts are called Carried Interest.

A frequently arising question in practice is the legal treatment of Carried Interest when the employment relationship between the *Fonds-Professional* and its employer company is terminated. In the vast majority of cases, terminations result in a settlement between the employer and the employee, that provides for the termination of the employment relationship while the employee receives a severance payment. This is even stipulated by German labour law in certain cases, such as terminations for operational reasons or the termination of the employment relationship by the court under Sec. 1a, 9 of the Protection Against Dismissal Act (*Kündigungsschutzgesetz*, referred to in the paper as *KSchG*). The calculation of the severance payment is based on Sec. 10 *KSchG*, which refers to the employees “monthly earnings” (“*Monatsverdienst*”).

Severance payments will often be made as well when the employment relationship between the *Fonds-Professional* and its employer company ends. Since Carried Interest makes up for a large part of the *Fonds-Professionals* remuneration, the question will regularly arise as to whether Carried Interest is also a part of the *Fonds-Professional's* “monthly earnings” and therefore must be included in the calculation of the severance payment. This would be the case if Carried Interest is a benefit from the employment relationship.

This is particularly questionable from a legal point of view as the employment relationship between the *Fonds-Professional* and its employer company on the one hand and the *Fonds-Professional* being a shareholder of the *Carry Company* on the other hand are two separate legal relationships. In analogy to the “separation theory” (“*Trennungstheorie*”) developed by the German Federal Labour Court (*Bundesarbeitsgericht*, referred to in the paper as “*BAG*”) on stock options granted by the parent company to the employee, both legal relationships being

completely separate from each other leads to the Carried Interest not playing any role in the calculation of the severance payment.

Other examples, such as company pension schemes or the receipt of tips also show that third party benefits cannot be included into the employment relationship without further elements of inclusion. However, such an element of inclusion does not normally exist in Carried Interest agreements. An explicit agreement on inclusion would make the Carried Interest an integral part of the employment relationship, but it is unlikely to be found in practice. Also, an implied agreement on the inclusion of the Carried Interest in the employment relationship will not be justifiable in the typical practical design of Carried Interest models. Finally, the provisions in the articles of association of the Carry Company provide that the Fonds-Professional must retransfer his shares in the Carry Company to the employer company after the end of his employment relationship with the employer company. He accordingly loses his claim to future Carried Interest. However, as the employer company does not legally declare its intent to become an additional debtor regarding the Carried Interest, these provisions do not result in the Carried Interest becoming part of the employment relationship. Similarly, it cannot be justified from the point of view of liability in good faith (“*Vertrauenshaftung*”) that the Carried Interest is part of the employment relationship.

However, even in the absence of an explicit or implied inclusion in the employment relationship, Carried Interest could still be included under circumvention aspects. If the Carried Interest being granted via separate corporate structures leads to a circumvention of labour law protection provisions, this could result in the Carried Interest being included into the employment relationship due to employee protection considerations. Yet, these considerations fail because Carried Interest is not a form of remuneration, as it does not legally form a part of the synallagmatic exchange relationship between employer and employee. Accordingly, the Fonds-Professional is not worthy of protection to the same extent as an employee who claims his or her contractual remuneration, so that no protective provisions under labour law are circumvented.

As a result, Carried Interest is a specific form of profit-sharing in the Private Equity-sector which is not part of the employment relationship and therefore does not have to be included in the calculation of the severance payment.

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