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Federal Court of Justice on the validity of Discretionary Termination Clauses in Leaver Schemes for Management Participation Programs

Clarification of the requirements for the objective justification of discretionary termination clauses

In its ruling of 10 February 2026 (Case No. II ZR 71/24), the Federal Court of Justice elucidated the conditions under which discretionary termination clauses – particularly in the context of management participation programs – are considered valid (so-called leaver clauses). The decision provides further guidance regarding the requirements for objective justification – and thus for the validity – of contractual provisions that grant shareholders the right to exclude a co-shareholder from the company without objective cause. The ruling is of great practical relevance to the field of management participation – specifically for partnerships (particularly general partnerships and limited partnerships) as well as for limited liability companies („LLCs“).

I. Background of the Decision

Management personnel are frequently bound to the company they oversee by means of so-called management participation programs. These programs are designed to engage said personnel with the opportunities and risks associated with the company's returns and value growth. This, in turn, serves to create an incentive for optimal performance. This practice has become firmly established in the domain of private equity investments; however, its prevalence extends beyond this specific field. The objective of such participation program is to **align the interests** of the operational managers with those of the (other) shareholders.

A management participation program can be **structured in a number of different ways**. The range of these arrangements extends from contractual agreements and silent partnerships to what is considered a “true” equity participation.

The foundation of the case, which was adjudicated by the Federal Court of Justice (“***FCJ***”) on 10

February 2026, pertained to a management participation program that took the form of an **equity participation** arrangement. The managing director of the operating LLC had been granted the status of a limited partner in an investment company as part of a management participation program. The investment company, organised as a Limited Partnership ("***LP***"), held an indirect stake in the LLC, but did not itself engage in any operational activities. The LP's partnership agreement contained a clause that stipulated the terms and conditions of the termination of the managing director's position and his employment relationship at the operational LLC. In the event of such termination, the managing director's interest in the LP could be acquired by the other limited partners of the LP ("call option"). In accordance with the terms of the partnership agreement, the amount of the purchase price to be remitted to the departing partner was contingent upon the conditions under which the option was exercised. In the event of a "Bad Leaver Call Event", the manager would receive the lower of market value and his own investment. Conversely, in the event of a "Good Leaver Call Event", he would receive the full market value following a four-year vesting period (in the event of earlier departure, a distinction would be made between a "Vested Portion" and an "Unvested Portion").

The managing director in question believed the call option agreed upon in the partnership agreement, was, as a discretionary termination clause, **violating public policy and therefore void**; he therefore filed a lawsuit seeking the declaration that he remained a limited partner of the LP.

II. Key Points of the Decision

In its ruling, the FCJ concluded that the relevant clause in the partnership agreement was not contrary to public policy but was **valid**. The FCJ provided the following justification for its decision:

1. Discretionary exclusion clauses are generally void

The FCJ held that the relevant leaver clause in the partnership agreement was, in fact, a **discretionary exclusion clause**. This is because the provision in question grants the remaining shareholders the right to exclude a co-shareholder from the company without objective grounds. The FCJ asserts that such discretionary termination clauses would, in principle, contravene public policy in both partnerships and LLCs. Consequently, despite the encroachment on the contractual autonomy of the parties that accompanies the finding of unconscionability, such clauses are **generally void**. The argument positing the fundamental nullity of such clauses is that the partner who is threatened with expulsion must be protected. This is because the other party's unrestricted right to expel could be perceived by the shareholder as a disciplinary measure. Consequently, out of fear of being at the mercy of the shareholders entitled to expulsion, the shareholder would not freely exercise their membership rights or fulfil their shareholder obligations. Instead, they would submit to the other party's wishes ("sword of Damocles"). A discretionary termination clause thus generally constitutes a significant encroachment on the shareholder status of the affected shareholder, restricting their economic and personal freedom, which could result in the shareholder aligning their conduct not with the company's best interests, but with the will of the party entitled to expulsion.

2. Exception to the general rule of nullity in the case of management incentive programs

In its ruling, however, the FCJ clarified that there are exceptions to the general invalidity of such clauses. In its opinion, the validity of a discretionary termination clause is contingent upon its **objective justification** due to **exceptional circumstances**. In the context of **management participation programs**, this must be assessed by taking a **comprehensive view of all circumstances of the individual case**. The pivotal consideration is whether the status of shareholder was granted to the manager in consideration of **his role as managing director and for an objective associated with that role**, the relevance of which ceases upon the termination of his contractual relationship or activity in accordance with the articles of association or employment contract. **Furthermore**, it is imperative to ascertain whether**, considering its structure, his involvement as a shareholder possesses any independent significance that is not otherwise relevant in relation to his capacity as managing director**.

3. Recognition of the incentive function of management participation programs by the FCJ

Further, the FCJ expressly recognised the interests of the company and the central objective of a management participation program, namely the retention of managers by aligning their interests with those of the company and increasing their motivation. In the event of the termination of the manager's board or employment relationship, it is evident that the purpose justifying participation – i.e. the retention of the manager, the increase in motivation, and the reward for successful performance – ceases to apply. Moreover, it is only through the retransfer of the shares that the company is afforded the opportunity to grant the successor to the position of managing director a participation under the same conditions. The significance of this incentive and retention function cannot be understated just because the manager in question did not participate in the company's current profits. Instead, as is customary in private equity structures, his involvement was limited to the **proceeds from the subsequent sale of the company**. However, the incentive and reward function in such a case is justified, particularly in private equity business models, by the objective of the majority of shareholders. This objective is often not directed toward a sustained increase in the company's current profits, but rather toward an increase in the company's value in order to achieve the highest possible sale proceeds.

4. The extent of the economic risk assumed by the manager is not a prerequisite for objective justification

Finally, according to the FCJ, the objective justification for a discretionary termination clause within the framework of a management participation program does not necessarily require that the manager assumes no **economic risk** or only a minimal one. The fact that, in the case decided by the FCJ, the managing director in question had assumed a not insignificant economic risk by acquiring his stake not at par value but at market value, and would likewise receive, in the event of his departure, a maximum of the market value of the stake pursuant to the agreed leaver clause, does not therefore preclude objective justification. In this particular instance, however, the entrepreneurial risk assumed by the managing director was not sufficient to assign his interest **independent weight** in the required overall assessment. This was because the possibility of enforcing his own ideas – even against the will of the other partners – or of effectively influencing the management of the limited partnership by exercising his rights as a limited partner was, under the statutory and contractual provisions, practically ruled out for him in this specific case. The question of whether the leaver payment to be paid to the plaintiff in the event of his expulsion (or the purchase price following the exercise of the call option) is unreasonably low because, under certain circumstances, he might not even be entitled to an appropriate reward for his successful management activities as a so-called "good leaver," is irrelevant to the validity of the **termination clause.** Rather, it is only relevant to the validity of the **leaver payment clause**.

III. Practical Consequences of the Decision

The FCJ provides clarity for practice and enables more stable framework conditions for investment structures. Particularly in the context of private equity investments, the leaver clause assessed by the FCJ is an established market standard.

The decision is of particular significance, especially in light of previous lower court case law that applied divergent criteria in assessing the admissibility of leaver clauses. The courts applied varying degrees of strictness, particularly regarding the existence of "special circumstances" that could justify a discretionary termination clause. Additional legal uncertainty was also caused by the recent case law of the Federal Labor Court regarding the inadmissibility of virtual employee participation programs.

The ruling of the FCJ has provided clarity on the matter of the inclusion of call options and termination clauses within articles of association. The following points are of particular relevance in practice:

- The clause must be based on an incentive and retention function.
- A proportion of the exit proceeds may suffice.

- The assumption of an economic risk by the shareholder does not, *per se,* preclude the validity of discretionary leaver clauses.

The validity of a discretionary leaver clause and the reasonableness of the leaver payment must be clearly distinguished.

Consequently, the FCJ's ruling transcends the particulars of the case at hand, thereby providing fundamental guidance for the legally sound structuring of participation models.

IV. Conclusion

The FCJ continues its previous case law and clarifies it in a manner favourable to investors regarding discretionary termination clauses (so-called leaver clauses). This enables legal advisors to structure management participation programs with greater legal certainty.

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This client information contains only a non-binding overview of the subject area addressed in it. It does not replace legal advice. Please do not hesitate to contact us for this client information and for advice:

Dr. Stefan Zeyher
Rechtsanwalt | Partner
M&A | Corporate Law | Litigation & Arbitration

T +49 621 4257 331
T +49 89 4111417 331
E Stefan.Zeyher@sza.de

Dr. Wilhelm Wucherer, B.Sc.
Rechtsanwalt | Senior Associate
M&A | Corporate Law | Litigation & Arbitration

T +49 89 4111417 446
E Wilhelm.Wucherer@sza.de

Dr. Nils Meyer-Eller
Rechtsanwalt | Associate
M&A | Corporate Law | Litigation & Arbitration

T +49 89 4111417 467
E Nils.Meyer-Eller@sza.de