Driving Performance: Incentive Structures from an Entrepreneurial and Legal Perspective

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Content

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I. Question

The startup, after an extensive search, identified its desired CEO candidate. This candidate, currently a department head at a large company, requires: a base salary; a performance-based annual bonus of 40% tied to pre-defined goals; stock options amounting to 5% of all company shares (with anti-dilution protection); partial vesting of these options upon commencement of employment; and six months' salary as severance pay.

To assess the CEO compensation package, consider the following:

Bonus Goals: The nature of the "clearly pre-determined goals" needs clarification. Are they aligned with long-term value creation and company strategy? Even with pre-determined goals, average performance could trigger a bonus, essentially making it salary.

Stock Options: Awarding substantial options solely based on time, with immediate partial vesting and anti-dilution protection, is atypical. The automatic increase with capital increases may also present legal challenges. Performance-based vesting linking vesting of options to achievements of goals should be considered.

Severance Pay: Six months' severance is legally permissible for private companies. A shorter notice period could offset the severance cost and benefit the company.

II. Initial Situation

1. Special Needs of Private Growth Companies

Venture capital-backed innovation companies, often operating as "ongoing disruptors," require constantly adapting strategies to challenge established business models.[1] Innovation companies, compete with established corporations for talent. To attract employees with specialized expertise from these larger companies, startups leverage their agile structure, flat hierarchies, and increased employee autonomy.[2] Early-stage growth companies often face challenges matching market-rate cash salaries. They typically compensate by offering equity.[3] They also aim to minimize financial impact upon employee departure.[4] While salary adjustments may occur after funding rounds, they often don't fully bridge the gap with larger companies. Balancing risk appetite is crucial: innovative models often require high risk, but employees investing their human capital are typically risk-averse due to the potential consequences of company failure. Unlike shareholders,

[1] BURCHMANN/JONES, 5.

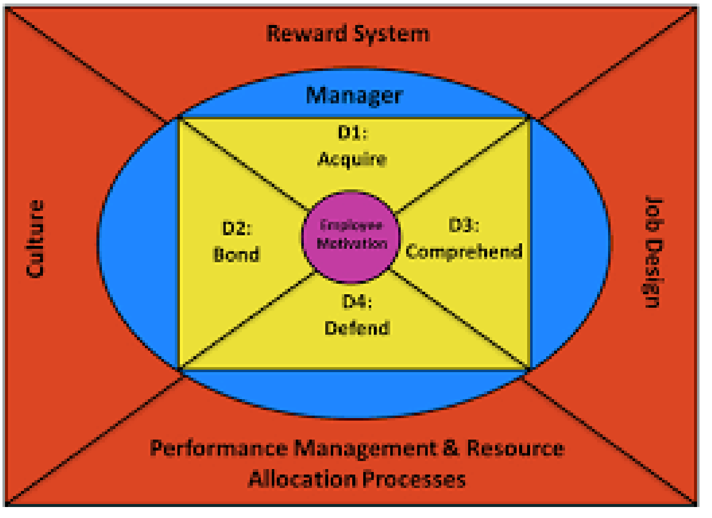
[2] JAZYLO.

[3] EYBEN.

[4] FRIEDMAN.

employees have limited diversification options.[5] Growth companies need compensation models that tolerate short-term setbacks while still rewarding long-term success.

2. Motivation - Foundation and Driver



Source: GROYSBERG/NOHRIA, *Harvard Business*

Employee motivation, comprising intrinsic (self-motivation) and extrinsic (incentivized) factors, is crucial. Managers can foster intrinsic motivation through role modeling, clear structure, delegation, respect for individuality, and shared success.[6]

Extrinsic motivation can be strengthened through financial and non-financial incentives.

a) Non-Financial Incentives

Corporate culture, the shared values and beliefs influencing employee behavior, plays a key role in non-financial incentives.[7] Signs of a culture of success are motivated employees who enjoy coming to work, orientation toward performance, and the will to successfully prevail even in intense international competition.

Employees at growth companies (startups) value increased autonomy, diverse work, faster learning and experience gain, and the visible impact of their contributions.[8]

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[5] MAHLER/VON DER CRONE, 547.

[6] BORK/ENGELEN, 9.

[7] PALEPU, 4.

[8] BORK/ENGELEN, 7; PALEPU, 7; V. SALIS, 274 f.

A welcoming culture, including quick onboarding and honest feedback, is also essential.

Employee dissatisfaction leading to departure is often attributed to limited growth opportunities, inadequate compensation, and a negative corporate culture.[9] Management quality and work-life balance are cited less frequently as reasons for leaving, potentially due to response bias.[10]

b) Financial Incentives

Market-rate compensation aims to attract, motivate, and retain top talent, aligning employer and employee interests.[11]A company's remuneration policy defines its compensation purpose, objectives, core components, and responsible parties.[12]

Despite a somewhat paternalistic approach to employee participation in Switzerland, its stated purposes, according to the highest courts, include attracting qualified talent, motivating employees through shared value creation, retaining management, and aligning shareholder, management, and employee goals.[13] While those aims are valid, they're incomplete: Growth companies, focused on survival, require attractive participation models to implement their ideas. The core goal is creating a high-performance culture driving a team towards long-term goals. Inappropriate compensation models can lead to negative behaviors, demotivation due to perceived unfairness, or excessive pressure.[14] Furthermore, company failure doubly impacts employees: job loss combined with decreased value of any equity participation. [15]

III. Driving Performance: Best Practice in Compensation

1. Four Central Parameters

Compensation models revolve around four key parameters: fixed vs. variable; short-term vs. long-term; cash vs. equity participation; and individual vs. company-wide performance. Growth companies should balance short-term and long-term variable compensation, acknowledging their higher risk of setbacks. Overemphasis on short-term

[9] CHAMBERLAIN, 3.

[10] CHAMBERLAIN, 4.

[11] ARHELGER; PAIR, 26.

[12] SRINIVASAN, Designing Executive Compensation at Kongsberg Automotive, 20.

[13] BGE 130 III 495, 503; MEIER SCHLEICH, 62.

[14] DANIELS et al, 2.

[15] HELBLING, 58.

variable incentives should be avoided, with a clear link established between company performance and variable rewards.[16]

The ideal compensation model links strategic goal achievement with compensation, fostering long-term profitable growth.[17] Relevant compensation criteria, both financial and non-financial, including ESG factors, should reward performance aligned with company purpose, strategy, and objectives.[18] The key is defining easily explainable targets that, when met, sustainably impact profitability.[19]

Easily achievable goals can breed complacency and hinder high performers. Stretch goals, exceeding budget or plan, can create organizational tension, potentially unsettling employees while also fostering creativity and recognizing courage. Failing to reach stretch goals can be perceived as collective failure. [20]

While easily attainable goals risk complacency and limit high-achievers, stretch goals - those exceeding planned targets - can foster creativity and reward ambition, but also create potential employee anxiety and the risk of perceived collective failure if unmet.[21] Cash compensation (base salary and cash bonuses) typically comprises a significant portion (often 50% or more) of total compensation in Switzerland.[22] Larger companies increasingly use restricted shares or similar instruments (e.g., RSUs, PSUs) for variable compensation, often based on past performance (*fire and forget*).[23]

2. Compensation and Incentive Systems Must Be Competitive

Growth companies, competing with larger corporations for talent[24], must offer competitive total compensation packages that is in line with the market and performance to attract and retain skilled individuals.[25] While equity programs are significant in attracting talent, companies often contradict this importance upon employee separation by treating these compensation elements discretionarily.[26]

[16] ISS (Institutional Shareholder Services), 26.

[17] GREINER/JULIAN.

[18] ISS (Institutional Shareholder Services), 26.

[19] SRINIVASAN, Current Considerations for Compensation Committees, 14.

[20] SRINIVASAN, Henkel - Driving Performance, 7.

[21] GREINER/JULIAN.

[22] SCHMID / WAGNER, 11.

[23] GLOOR et al, 574.

[24] GREINER/JULIAN; PAIR, 26.

[25] 2023 Swiss Code of Best Practice for Corporate Governance, 22

[26] OERTLE, 8.

Compensation benchmarking often relies on comparable companies, typically selected by consultants or management based on industry, revenue, and employee count. Comparability is often limited because data primarily originates from public companies. The Board of Directors' Compensation Committee's role is to critically evaluate the peer group's composition and the relevance of compensation comparisons.

3. Compensation Models Must Be Fair and Equitable

Ethical compensation models must satisfy four fairness criteria: performance justice, distributive justice, procedural justice (equal opportunity), and needs-based justice.[27] However, business ethics cannot definitively determine the appropriate level of compensation.[28]

Fairness generally dictates equal treatment of employees and investors in a company sale, typically through accelerated vesting of all equity rights, enabling employees to exercise options and transfer shares or options directly to the buyer. [29]

4. Compensation Models Must Be Comprehensible

Compensation systems should be transparent and produce understandable outcomes[30]. Employees must know whether rewards are based on individual or company performance and if they are determined solely at the company's discretion.[31] Transparent systems use measurable, openly communicated goals. Employee awareness of internal compensation levels is common.[32] Concrete targets are typically more motivating than purely discretionary bonuses.[33] To avoid stifling creativity with overly prescriptive "*tick the box*" checklists, carefully crafted targets and active communication with employees are essential.[34]

Equity grants must have clearly defined parameters: Does the percentage relate to fully diluted shares? Are options or shares granted, and what are the rights of each share class?

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[27] DAENIKER/PESTALOZZI, 400.

[28] DAENIKER/PESTALOZZI, 400.

[29] ARHELGER.

[30] 2023 Swiss Code of Best Practice for Corporate Governance, 22.

[31] OERTLE, 8.

[32] A Counterintuitive System for Startup Compensation, available at <https://review.firstround.com/A-Counterintuitive-System-for-Startup-Compensation>.

[33] OERTLE, 8.

[34] EYBEN; KUIPERS et al, 27.

What is the expected dilution and at what price? What is the exercise price? Is accelerated vesting upon exit included?[35]

5. Reward for (Past) Performance

Equity programs aim to foster entrepreneurial thinking and company identification.[36] Ideally, employees can influence goal setting. While teamwork is crucial, a balance must be struck between company-wide goals and individual performance incentives. [37] KPIs (*key performance indicators*) defining long-term value are often employed. [38]

In larger companies, higher executive compensation can incentivize lower-level employees seeking promotion (tournament theory).[39] Conversely, there is also the view that excessive, performance-decoupled compensation can undermine intrinsic motivation. [40]

Effective compensation systems must reflect negative performance[41], eliminating the risk of rewarding failure.[42] Compensation should align with both financial and non-financial company performance, avoiding significant discrepancies.[43] The 2023 Swiss Code of Best Practice for Corporate Governance summarizes this as follows:

> The compensation should be based on criteria that are also comprehensible for third parties and are geared towards the sustainable achievement of the company's objectives. The board of directors can link the variable compensation to specific compliance and other sustainability objectives.[…]. The compensation system should be designed in such a way that total compensation is reduced if certain objectives are not achieved (malus).[44]

6. Focus on Long-Term Success

Equity compensation programs effectively incentivize long-term success.[45] Maintaining a balance between compensation and performance, focused on long-term shareholder value, is crucial.[46] Allocating shares and granting options (or similar instruments) have

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[35] See How to Negotiate your Equity Compensation in VC-Backed Startups, May 2012, available at <https://accountalent.com/how-to-negotiate-your-equity-compensation-in-vc-backed-startups/>.

[36] JAEGER, 11.

[37] KUIPERS et al, 21.

[38] KUIPERS et al, 27.

[39] MALACRIDA/SPILLMANN, 349.

[40] MALACRIDA/SPILLMANN,349 with further references.

[41] MAHLER/VON DER CRONE, 552.

[42] ISS (Institutional Shareholder Services), 26.

[43] ISS (Institutional Shareholder Services), 26.

[44] 2023 Swiss Code of Best Practice for Corporate Governance, 22.

[45] BUCHER et al, 7.

[46] ISS (Institutional Shareholder Services), 24.

different effects. Options offer greater potential profit (leverage) but also greater risk of total loss.

Participation rights, often granted at the start of employment (*front-loading*), typically cover three to four years. The vesting period, during which the employee "earns" the option, can be performance-based (meeting targets) or time-based (remaining employed). "Vesting" refers to the end of this period.[47] Before vesting, these rights are conditional and legally classified as entitlements.[48] A one-year minimal period (*cliff vesting*) typically prevents short-term employees from benefiting from participation programs..

Participation programs help align investor and founder interests by sharing the effort required for growth[49]. Founders who continue to be active in the company often receive part of their compensation this way. While intended to promote long-term success, options can incentivize excessive risk-taking when their value drops but could recover through risky actions.[50]

7. Compensation Models Must Create Trust

Compensation and incentive systems require consistency. Frequent changes breed uncertainty, inequality, and erode trust. Limiting formal compensation discussions to once or twice yearly promotes a positive work environment.[51]

8. Participation Programs Must be Financed

Funding is essential for participation programs. Virtual programs must ensure liabilities are incurred only when affordable or deductible from a sale price. Share/option plans require reserved shares, typically through conditional capital, sometimes treasury shares, rarely shares from related parties. Share availability limits are an argument against a contractual agreement of automatic increases with each capital raise (*evergreen clauses*).

[47] Judgment of the Federal Supreme Court 2C_138/2010 of 2.6.2010, E. 2.2; NÖTZLI, 578 and 579.

[48] Circular No. 37, Taxation of Employee Stock Ownership Plans (2013), para. 2.4; Circular No. 37a, Taxation of Employee Stock Ownership Plans with the Employer (2018), para. 5.1.

[49] TROXLER, 209 f.

[50] VERMEULEN.

[51] A Counterintuitive System for Startup Compensation, available at <https://review.firstround.com/A-Counterintuitive-System-for-Startup-Compensation>.

9. Avoidance of Taxable Income at The Wrong Time

Tax considerations significantly influence the design of participation programs.[52] Employees generally avoid paying taxes on the grant of participation rights (*dry income*).[53]

10. Participation Programs and Exit

Participation programs, especially in innovative companies, must consider the exit strategy (sale or IPO). Attractive early exercise of share options can significantly increase shareholder numbers, favoring virtual option plans (VSOPs).[54] Private equity holdings are illiquid except in rare instances, such as a company sale.[55] Shareholding programs are ineffective without a realistic medium- to long-term exit. While a put option upon exit can mitigate the illiquidity of private equity, it requires free cash often unavailable in young growth companies.[56]

While participation programs typically require joining the shareholders' agreement (SHA) upon option exercise, its suitability is debatable. Many SHA provisions focus on investor rights, with only some (e.g., transfer restrictions, sale procedures) relevant to employees. [57] Alternatives include incorporating these rules into regulations or creating a separate SHA.

A lock-up on option exercise can limit the number of shareholders. This typically doesn't restrict employees, as pre-exit exercise is usually tax-disadvantageous.

11. Voting Advisor Specifications

Companies planning an IPO should consider proxy advisor guidelines.[58] Proxy advisors, such as ISS (*Institutional Shareholder Services*), publish guidelines on share-based compensation. ISS suggests outstanding plan obligations not exceed 5% of issued share capital, or up to 10% for high-growth companies or plans with stringent criteria/extended vesting. This is lower than the 15% common in private growth companies.[59] Full vesting should take at least three years, potentially tied to performance targets measured

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[52] NEERACHER/SEILER/ANNASOHN, 11.

[53] FRECH; on tax parameters, see VERMEULEN and generally HEUBERGER, 167 ff.

[54] PRENGEL.

[55] JACKSON, 655.

[56] See <https://www.mitarbeiterbeteiligungen.ch/rueckgabepflicht-rueckgaberecht>; V. SALIS, 288.

[57] NEERACHER/SEILER/ANNASOHN, 13; PAIR, 28.

[58] EYBEN; critically, PAINE, 4: "mechanistic evaluation of proxy advisors."

[59] ISS (Institutional Shareholder Services), 27.

over three consecutive years.[60] Granting stock options, performance-based equity (including stock appreciation rights and performance shares), and performance-based cash to non-executive directors is generally discouraged.[61]

IV. Driving Performance: Typical Participation Models

Swiss practice shows various participation models. In the case of privately held companies, most models can be reduced to three forms, namely a share plan (real or virtual), an option plan (also real or virtual) and the participation model for managers in private equity-financed takeovers. In addition, there is the special case of the founding team before the first round of financing.

a) Share Plan

Share plans allow employees to acquire company shares at preferential terms, sometimes at par or free. These shares often have a two- to four-year lock-up period. Companies may retain repurchase rights at a predetermined (often low) price if the employee leaves within a specific timeframe (e.g., three years).

b) Option Plan

Option plans (ESOPs) grant employees the right to purchase ordinary shares (often 15% total) within a timeframe (often ten years) at a fixed exercise price, typically the fair value at grant date. Vesting usually occurs over three to four years (monthly or quarterly) with a one-year cliff. For companies with fully participating preferred shares (simple double-dip), US specialists often value common shares at 20-35% of the preferred share price in the last funding round.[62]

c) Sweet and Strip Equity in Private Equity Transaction

In private equity transactions, management typically receives 5-10% of common stock at fair value, sometimes financed by investors (*sweet equity*). In contrast, the invest-

[60] ISS (Institutional Shareholder Services), 28; likewise, the 2023 Swiss Code of Best Practice for Corporate Governance, 18 recommends appropriate performance criteria and meaningful maturity matching.

[61] ISS (Institutional Shareholder Services), 26; also 2023 Swiss Code of Best Practice for Corporate Governance, 22.

[62] So-called 409A valuation, as Section 409A of the U.S. Internal Revenue Code provides for an additional tax of 20% when the exercise price of options is lower than the market value.

ments of private equity investors are referred to as the *institutional strip*. Selling managers usually reinvest 20-50% of their sale proceeds into the acquiring company (*strip equity*, or *roll-over shares*).[63] A separate share class may be used, ranked behind a minimum investor return. Sweet equity and strip equity have different exit treatments. Repurchase rights/obligations at fair value, or good/bad leaver provisions, apply to sweet equity but not strip equity.

d) Special Case: Adaptation of The Founding Team

Incentivizing founding teams pre-financing requires special consideration, as market-rate salaries are often unaffordable. Disproportionate founder contributions may warrant compensation through founder share redistribution.[64] Rigidly adhering to initial allocations can exacerbate free-rider issues, while early fixed allocations, though clear, can create future disincentives.[65] It is recommended that such an adjustment in principle be agreed in advance and confirmed by means of a tax ruling.[66]

1. Tax Law Impact[67]

Tax considerations often drive investment instrument choices. The following summarizes key tax aspects impacting equity program structure.

a) Shares

Granting or selling shares generates taxable income equal to the difference between the purchase price and fair market value. A 6% annual deduction from fair market value applies for each year the shares are blocked. Listed companies must use the market price. Private companies may use a recognized valuation formula.[68] After a five-year holding period, a tax-free capital gain is realized on a subsequent sale if the valuation method

[63] NEERACHER/SEILER/ANNASOHN, 11.

[64] NEVRLKA, 157 ff. and 193 ff.

[65] KAGAN/LOVEJOY/LEIDER, 7 and 30.

[66] See <https://www.netzwoche.ch/news/2019-11-06/zuercher-finanzdirektion-reagiert-auf-start-up-beduerfnisse>; OESTERHELT, STEFAN / SCHREIBER, SUSANNE, Abgrenzung von Gründeraktien gegenüber Mitarbeiteraktien, StR 2023, 90.

[67] See HEUBERGER in detail.

[68] In this context, the calculation of the corresponding value at the time of allocation may follow the rules set out in Circular No. 28 of the Swiss Tax Conference of 28.8.2008 (Guide to the valuation of securities without market value for wealth tax purposes); this formula value can also used even if there is a market value – see Kreisschreiben Nr. 37 (30.10.2020, Besteuerung von Mitarbeiterbeteiligungen) of the Federal Tax Administration, para. 3.2.2.2. as long as the Company has a unrestricted call option.

changes from formula to fair value.[69] In case of an earlier exit, all gain will constitute taxable income. Different rules may apply in special cases like sweet equity[70]

b) Virtual Shares or Virtual Options

Virtual stock ownership plans (VSOPs) with virtual shares (*restricted stock units*, RSUs) or virtual options (*stock appreciation rights*, *SARs*) are pure debt instruments based on share value.[71] Legally, they represent an entitlement, taxable as salary only upon pay-out[72]. This avoids "dry income" but precludes tax-free capital gains.

c) Options

In the case of options of privately held companies, only the exercise of the option (i.e. the acquisition of the share) generates taxable income, calculated as the difference between market value at exercise and the exercise price. Determining fair market value is key, but some cantonal tax administrations struggle to differentiate common and preferred share values or wrongly dismiss shareholder agreements affecting transferability as tax-irrelevant.[73] Ignoring the economic reality that preferred share rights often yield higher proceeds upon company sale, some tax authorities wrongly discount shareholder agreements as solely affecting transferability, when they actually define economic rights. This misunderstanding creates friction between companies and authorities, harming Switzerland's attractiveness for innovation. The introduction of formula-based share valuation in 2020 offers some relief.[74] Subsequent share sales can yield tax-free capital gains if the shift from formula to fair value occurs after a five-year holding period[75]. Realization within five years results in tax-free gains up to the formula value; any excess gain is taxable.

d) Social Security Contributions

Social security contributions must also be considered. For the pension scheme (BVG), the actual salary paid, excluding occasional components, is relevant.[76] The pension fund

[69] Circular No. 37, version of October 30, 2020, para. 3.4.3.

[70] OESTERHELT STEFAN, RISI VÉRONIQUE, Steuerliche Behandlung von Sweet Equity, EF 2023, 549-553

[71] See <https://www.mitarbeiterbeteiligungen.ch/mitarbeiterbeteiligungs-arten/phantom-stocks-stock-appreciation-rights>.

[72] HERREN, 987.

[73] Analogous application of para. 61 of circular no. 28 of the Swiss Tax Conference dated August 28, 2008 (Guidance on the valuation of securities without market value for wealth tax purposes).

[74] For the formula value, see footnote 68 above.

[75] Circular No. 37, version of October 30,.2020, para. 3.4.3.

[76] KONRAD/LAUENER, 385 ff.

regulation should explicitly exclude participation program income from eligible salary. In case of delayed compensation (e.g., milestone payments post-sale), companies remain fully liable for social security contributions.[77] Employee contributions can be transferred to the payment recipient, applying either realization or determination principles for thresholds.[78] Employer contributions are governed by the share purchase agreement and potentially ESOP regulations. While transferring the employer's contribution burden to the employee is generally disallowed, exceptions exist.[79]

2. Impact of Employment Law

Employment law requirements, frequently driven by social policy, can have unanticipated impacts on participation programs.

a) Formal Requirements

Participation programs may, but need not, be agreed as part of the employment contract. Employment law applies regardless of any contractual stipulations. Therefore, it is advisable to include a clause in the employment contract reserving the right to modify or revoke non-contractually guaranteed compensation elements.[80]

b) Principle of Equality

Based on the principle of equality, employees may have a right to participate in a program if a substantial portion of their colleagues already participates.[81] Therefore, restricting an ESOP to a single department (e.g., research) without objective justification

[77] Art. 14 para. 1 AHVG.

[78] BLUNIER/JACCARD, 357.

[79] Due to the principle of parity of contributions, contractual agreements are inadmissible which allow the employer to deduct from the employee's gross salary, in addition to the employee's contributions, the employer's contributions actually attributable to the employee (BGE 107 II 436 ff.). Exceptions may be made in special circumstances, such as in the case of a salary expressed as a percentage of sales or turnover, provided that the parties have taken into account the transfer of the entire tax burden to the employee by increasing the amount due (cf. BGE 107 II 436, JAR 1996, 98, E. 2a). Moreover, the nominal passing on of social security contributions must not be based on abusive intentions or intentions aimed at circumventing the law (BGE 127 III 449 f.) However, the passing on of contributions appears to be possible in the case of payments of an uncertain amount, provided that it is transparent for the employee and the employer can prove that it was priced into the amount of the allocation when the amount of the participation rights was determined, analogous to the case where the salary was determined on the basis of a percentage of sales or turnover (cf. BGE 107 II 436, JAR 1996, 98, E. 2a).

[80] Cf. <https://www.mitarbeiterbeteiligungen.ch/beteiligungsreglement/erlass-beteiligungsreglement>.

[81] PAIR, 29, CARDINAUX, 347.

is problematic. A right to participate may also exist if denial could be construed as discriminatory towards the employee.[82] However, this principle is difficult to enforce legally and therefore provides limited grounds for concrete rights. Moreover, employees reportedly react more negatively to unequal treatment in participation programs than in cash compensation.[83]

c) *Salary or Gratuity?*

The salary portion of the compensation is specifically protected by law. Employees cannot be held liable for company losses through deductions from their salary.[84]

Legal regulations regarding variable salary components are fragmented. For instance, rights of control and inspection exist if a share in sales or profits is agreed upon.[85] Additionally, there is a tricky regulation concerning gratuities: "Where the employer pays a bonus over and above the salary on particular occasions, such as at Christmas or the end of the financial year, the employee is entitled to such bonus where it is contractually stipulated."[86] If such entitlement exists, a gratuity is due even if employment terminates mid-year. This fragmented regulatory landscape often makes variable compensation a source of contention. [87]

The following three case constellations are to be distinguished:

aa) *Variable Compensation Agreed in Principle and Amount*

Transparent systems use clearly communicated, concrete, and measurable targets. Objectively measurable targets create a legally enforceable claim to special remuneration, qualifying as variable salary even if labeled a gratuity. [88] If a performance-based bonus is agreed upon but no specific targets are defined, the employer breaches their obligation, resulting in the full bonus being owed for average performance. [89] Unilaterally increasing targets constitutes a modification of the employment contract. [90]

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[82] RUDOLPH/STREIFF/VON KAENEL 342.

[83] KAGAN/LOVEJOY/LEIDER, 7.

[84] Cf. <https://www.mitarbeiterbeteiligungen.ch/bemessung-mitarbeiterbeteiligung>.

[85] Art. 322a and Art. 322b CO.

[86] 322d para. 1 CO.

[87] RUDOLPH, 92.

[88] BGE 139 III 155; OERTLE,, 9; RUDOLPH/STREIFF/VON KAENEL, 345.

[89] RUDOLPH/STREIFF/VON KAENEL, 345 f.

[90] LIENHARD, 1272

bb) Variable Compensation Agreed in Principle, Amount at Discretion

Even if a bonus is undefined or subjectively determined, case law establishes a right to payment (allowing the employer some discretion regarding the amount) if the contract generally stipulates a bonus payment[91] or if a bonus was regularly paid without a contractual agreement specifying its discretionary nature. [92]

A contractual clause requiring written amendments does not prevent this, as implied contract modifications can be inferred from the parties' conduct.[93] Targets linked to personal development or subjective employer assessments of employee performance are not objectively measurable.[94]

cc) Variable Compensation at Discretion Both in Principle and Amount

If the bonus's existence and amount are not contractually fixed, and prior payments were discretionary, the variable compensation remains entirely at the employer's discretion. Two case law exceptions exist: A claim can arise following three years of discretionary gratuity payments if the employer never invoked the discretionary nature of the payments even when justified by poor company or employee performance.[95] According to the Federal Supreme Court, to maintain its nature as special compensation, a gratuity must be secondary to the base salary.[96] This is unlikely if the bonus regularly exceeds the salary.[97] This practice aims to prevent employers from paying actual remuneration disguised as a (discretionary) gratuity. This practice aims to prevent employers from paying actual compensation disguised as discretionary gratuities. Therefore, a gratuity cannot constitute the sole or primary component of an employee's remuneration[98]. This "accessoriness" requirement, however, is widely criticized as an undue infringement of private autonomy.[99] Critics argue that enforcing it would require the Federal Supreme Court to reclassify part of the compensation as salary, effectively dictating appropriate

[91] BGE 136 III 313, E. 2; BGer 4A_513/2017, of September 5, 2018, E. 5.3.1.

[92] BGer 4A_280/2020 of March 3, 2021, E.5, see in this respect PRINZ/GEEL.

[93] BGE 4A_443/2010; Basel-Stadt Labor Court Judgment of October 23, 2017; GS 2016.11, BJM 2019 pp. 273, 279.

[94] BGE 142 III 381, E. 2.1; BGer 4A_513/2017 of September 5, 2018, E. 5.2.2.

[95] BGE 129 III 276, E. 2.3 at p. 280 f.; 131 III 615, E. 5.2. at p. 620; BGer 4A_513/2017 of September 5, 2018, E. 5.3.2; PRINZ / GEEL.

[96] BGE 139 III 155, 157.

[97] BGE 129 III 276, E. 2.1 at p. 279 f.; confirmed in BGE 139 III 155, 157.

[98] BGer 4A_155/2019 of December 18, 2019, E. 6.3 with further references.

[99] RUDOLPH, 93 f.; RUDOLPH/STREIFF/VON KAENEL, 336 f.; STAEHELIN, 183 f.

salary levels. [100] However, once the actual salary sufficiently covers an employee's living expenses, the gratuity's size relative to the salary is no longer a relevant criterion for determining its nature.[101]

Salary protection regulations cease to apply when salary exceeds five times the median wage. [102] For lower salaries, a case-by-case assessment is necessary: with low total income, even a proportionally smaller bonus may be considered a (variable) salary component due to the greater impact of small income differences. For medium to higher incomes, a very large bonus relative to salary, a bonus equal to salary, or a regularly paid bonus exceeding salary may exceptionally be a (variable) salary component despite being contractually voluntary. [103]

d) Consequences if Salary

Qualifying an equity compensation program as a wage component can have far-reaching consequences:[104]

aa) Mandatory Provisions Regarding Origination of The Claim, Parameters of Assessment and Due Date

Classifying compensation as salary prevents reductions due to poor company performance, as employers cannot transfer business risks related to salary to employees. [105] This highlights a disconnect between case law and reality: if business performance is a target, variable compensation is directly dependent on it.

Classifying participation programs as salary can be problematic if, for instance, vesting is misconstrued as an impermissible forfeiture or "*claw-back*." [106] Additionally, it raises questions about the permissibility of call options and other shareholder agreement obligations when participation rights are acquired as salary. [107]

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[100] BGE 141 III 407, E. 4.3.2; BGer 4A_513 /2017, E. 5.4; critically RUDOLPH et al., 338 f.

[101] BGE 139 III 155, 159; CRAMER, 110 ff.

[102] BGE 141 III 407, E. 5.3.3; BGer 4A_513/2017, E. 5.4; NEDI/SCHERER, 143; for 2022, this would be 60 times CHF 6,788 i.e. CHF 407'280, see < https://www.bfs.admin.ch/bfs/de/home/statistiken/arbeit-erwerb/loehne-erwerbseinkommen-arbeitskosten.html >.

[103] BGE 142 III 381, 383.

[104] BGer 4A_155/2019 of 18.12.2019, E. 4.1 with further references; SENTI, 87 ff.

[105] MAHLER/VON DER CRONE, 552.

[106] See BGer 4A_653/2014 of August 11, 2014, E. 6; BARTHOLET/KURER, 373; NEDI/SCHERER, 143; NÖTZLI, 579.

[107] BOVET, 20; JACCARD/LEIS, 136 - 137; NEDI/SCHERER, 145.

bb) Minimum Reasonable Compensation

Currently, minimum salaries exist only through cantonal regulations or generally binding collective labor agreements. The Federal Supreme Court mandates appropriate compensation as a minimum for performance-based salaries, likely with the debt collection law's subsistence level as the lower bound.[108] While drawing a salary below subsistence level during a company's start-up phase violates employment law, it often goes unchallenged ("where there is no plaintiff, there is no judge").[109]

cc) Truck Prohibition

The truck system prohibition, originally found in the Factory Act and now codified in Article 323b para. 3 Swiss Code of Obligations aims to protect employees from being paid in goods instead of money[110]. A key exception exists: employees considered investors are not covered by this prohibition[111]. However, this exception's applicability is narrow as many participation plans do not require upfront capital investment or provide preferential terms.

The truck prohibition does not prohibit per see all in-kind payments. [112] However, salaries in kind may also not be used in the sole or predominant interest of the employer.[113] The prohibition ensures employees receive agreed-upon compensation. [114] Most participation rights fall outside this prohibition because they primarily benefit the employee; employers are typically unwilling to provide the equivalent value in cash. [115]

The truck prohibition therefore only applies, rendering agreements null and void, when employees are required to use cash salary to purchase participation rights[116] or when employers attempt to substitute cash salary components with participation rights.[117]

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108 BGer 4A_435/2015, E. 2.1; SENTI, 89.; https://www.mitarbeiterbeteiligungen.ch/bemessung-mitarbeiter-beteiligung

109 CARDINAUX, 341

110 Art. 323b para. 3 CO.

111 BGE 130 III 501; GABUS/ROMER, 225; NÖTZLI., 578; CATELLI CINZIA, WIDMER LAURA, TJON-A-MEEUW YVES, SJZ 2024, 193

112 BGE 131 III 615, 619 f.; BGE 130 III 19, 27; BGer 4C.237/2004 and 4C.239/2004 of October1, 2004, E. 3.1; BORTOLANI/SCHERRER, N 11 to Art. 322 OR.

113 NÖTZLI, 575 - 576.

114 SUMMER, 101

115 STAEHELIN, 185.

116 BORTOLANI/SCHERRER, N 10 to Art. 322 OR; PAIR, 29.

117 SUMMER, 104

dd) Obligation to Continue Payment upon Termination of Contract

Salary payments cannot be conditional on the employee maintaining an indefinite employment relationship at the time of payment. [118] Preemptive waivers or clauses requiring salary repayment upon resignation before a specific date are also invalid. [119] Thus, even upon termination, employees retain full entitlement to earned salary and determinable special compensation.[120]

Even if a gratuity's amount isn't specified, partial payment is due upon termination, as it compensates both past performance and future incentives. [121] The future-oriented portion can be reduced proportionally to unachieved goals. Unlike salary, however, contractual agreements modifying gratuity payments are generally permissible. [122] Based on this reasoning, some argue that forfeiting unvested or restricted shares/options granted as salary may be invalid. [123] This is not correct as granting 100 shares vesting over four years is legally equivalent to granting 25 shares annually for four years. Issues arise if already-vested shares are forfeited, such as in "bad leaver" clauses, often triggered by termination for cause [124] or even justified cause[125] or contract breaches (confidentiality, non-competition). Such forfeiture can be qualified as a reverse entitlement: The right for the delivery of shares is encumbered under the law of obligations and has the effect of a salary retention, which is only permissible within a very narrow legal framework.[126]

Are such forfeiture clauses subject to judicial review as contractual penalties? This is likely only applicable if the forfeiture results from a breach of contract, creating a typical penalty aimed at prevention or simplified damages calculation.[127]

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[118] BGer 4A_115/2007 of July 13, 2007, E. 4.3.1; BGer 4C_395/2005 of March 1, 2006, E. 5.2; BORTOLANI/SCHERRER, N 10 to Art. 322 OR; NÖTZLI, 576.

[119] BGer 4A_158/2019 of February 26, 2020, E. 5; NÖTZLI, 577.

[120] STAEHELIN, 347.

[121] STAEHELIN, 344; according to Basel and Zurich practice, a reduction by 1/3 is common, in Bern by 50%, while Geneva practice does not apply any reduction.

[122] LIENHARD, 1271; see also <https://www.mitarbeiterbeteiligungen.ch/kuerzung-verweigerung-beteiligung-sanspruch>.

[123] BORTOLANI/SCHERRER, N 10 to Art. 322 OR, with reference to BGE 139 III 155.

[124] Art. 337 CO.

[125] Art. 340c para. 2 CO; see NEERACHER/SEILER/ANNASON, 12.

[126] Art. 323a OR; NÖTZLI, 573; for German law, see DENGA, 734.

[127] Likewise on German law DENGA, 748.

ee) Reduction due to Breach of Duty

Minor breaches of duty can only justify reductions in discretionary compensation. Contractually guaranteed remuneration can only be reduced for serious breaches of duty.[128]

e) Protection against Dismissal

Protection against termination may also play a role: Terminating employment to prevent imminent vesting of participation rights could be deemed contrary to good faith.[129] The argument that vesting clauses unduly restrict termination freedom is rightly rejected.[130] They represent future entitlements, not "golden shackles."[131] Per the Federal Supreme Court, only contracts exceeding ten years violate personal freedom (Art. 27 Swiss Civil Code).[132] A *sign-on bonus* with a repayment obligation in the event of early departure may be agreed for a maximum of three years.[133]

f) Non-Competition

Non-competition clauses, often crucial for investors seeking to protect company secrets and know-how,[134] can hinder a manager's post-employment prospects, thus incentivizing continued employment. However, such clauses in employment contracts face limitations regarding duration, scope, and eligible employee groups.[135]

3. Corporate Law Impact

a) Appropriateness of the Remuneration

Granting participation rights must serve the company's interests and be commensurate with expected contributions. The board of directors' duty of loyalty and due diligence demands high responsibility, especially regarding their own compensation. The Federal

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[128] Cf. <https://www.mitarbeiterbeteiligungen.ch/kuerzung-verweigerung-beteiligungsanspruch>; and MALACRIDA/SPILLMANN, 352 f.

[129] PAIR, 28.

[130] Cf. <https://www.mitarbeiterbeteiligungen.ch/vesting-klausel>.

[131] See also STAEHELIN, 182.

[132] BGE 130 III 495, 504.

[133] Analogous to Art. 340c CO; RUDOLPH et al., 360.

[134] V. SALIS, 289.

[135] BOVET, 26; in contrast to the development in California outlawing sinc 1 January 2024 non-compete obligations in employment contracts (Cal. Bus. and Prof. Code §§ 16600, 16601, and 16602.5)

Supreme Court prioritizes the company's long-term interests.[136] This duty requires prioritizing company interests over personal ones, adhering to a strict standard.[137]

As early as 1960, the Federal Supreme Court ruled on the appropriateness of the remuneration of the Board of Directors:

> "As the Federal Supreme Court has already stated in its previous decisions, it is therefore necessary that the fixed remuneration is justified by the activities of the directors. One must examine whether the amount paid is proportionate to their work, to the services they have rendered to the company and to the situation of the company. [...] An augmentation of the remuneration of directors by the directors themselves may thus only be justified if the economic situation of the company has improved considerably."[138]

All unjustified remuneration is subject to repayment under Art. 678 of the Swiss Code of Obligations. Previous requirements concerning obvious disproportion of compensation to consideration, influenced by the company's economic situation, no longer apply.[139]

b) Admissibility of Severance Payments

While "at-will employment" with accompanying severance pay is common in the US, Swiss law prohibits severance payments for listed companies, though payment for obligations through the contract term isn't considered severance.[140] This prohibition influences privately held companies as well.[141]

V. Formal Implementation: Procedure and Process

1. Choice of Standard Solutions

Employee participation programs are inherently complex. The effort involved must be proportionate.[142] Customized solutions can create opacity and confusion. Standard market solutions are preferable, simplifying employee communication and future financing rounds.[143]

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[136] BGer 4A_55/2017, E.5; BERTSCHINGER, 403.

[137] BGer 4A_55/2017, E. 6.3; BERTSCHINGER, 399.

[138] BGE 86 II 163; see also DAENIKER/PESTALOZZI, 397 and BGE 105 II 114, 122.

[139] For the law in force until the end of 2022, see BGE 140 III 602 with further references; MAUCHLE /VON DER CRONE, 199.

[140] Art. 735c no. 1 OR, in force from January 1, 2023.

[141] MAHLER/VON DER CRONE, 547, footnote 44.

[142] FRECH.

[143] EYBEN.

2. Conflicts of Interest

Shareholding programs must be carefully drawn up. Conflicts of interest are particularly tricky, whether because individuals decide on their own compensation or because there are conflicting interests between shareholder and company or between different groups of shareholders. In the prime case of KPT, the repurchase of shares from governing bodies at an insufficiently documented price, the granting of unsecured loans to finance these repurchases, and separate consulting contracts for board members in clear violation of the board's duties of care and loyalty led to disbarments and convictions for disloyal management.[144]

3. Procedural Rules by Virtue of Corporate Law

Establishing employee participation programs is a non-delegable duty of the board of directors, requiring them to define at least the basic design, eligible participants, and key economic parameters. [145] Shareholders commonly define key program aspects in shareholder agreements, or utilize conditional share capital to secure majority shareholder approval. [146] For privately held companies, formal compensation regulations are not required by law but the Articles of association can adopt listed companies' "*say-on-pay*" rules for determining board/executive compensation.[147]

4. Sale of Shares Financed by Loans

Selling employee shares financed by employer loans is possible, as is transferring shares coupled with a negative exit preference (obligating a specific repurchase price, neutralizing the transfer's present value for tax purposes) [148]. Both models necessitate tax rulings before implementation.

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[144] Federal Administrative Court, B-19/2012 and B-798/2012, December 13, 2013; ENZ, 28; for supervised financial institutions, FINMA has formulated a number of principles in Circular 2010/1 (Remuneration Systems - Minimum Standards for Remuneration Systems at Financial Institutions), which oblige large firms to implement and which other firms must use as a guideline. These principles are not readily extendable to all firms, because in the financial sector so-called "*prudential corporate governance*" must be ensured so that creditors and the state are not harmed by excessive risks. Innovation firms in non-regulated sectors may (and must) have a greater risk appetite, see also BOHRER, 337.

[145] Art. 716a para. 1 CO; cf. <https://www.mitarbeiterbeteiligungen.ch/einfuehrungs-zustaendigkeit>; likewise the 2023 Swiss Code of Best Practice for Corporate Governance, 21.

[146] With art. 653 CO, in the version in force from January 1, 2023, the limitation to creditors or employees is omitted; cf. GERICKE, 111

[147] Art. 732 para. 2 CO, in force as of January 1, 2023; for the previous law, see FORSTMOSER/MEIER-HAYOZ,/NOBEL, Schweizerisches Aktienrecht, Bern 1996, §28, N 128

[148] See on German law FRECH.

5. Effect on Financial Statements and Income Taxes

While deferred compensation generally requires recognizing a provision for the full expected cost, [149] this differs for share-based compensation under Swiss Code of Obligations accounting versus IFRS. IFRS 2 mandates expensing share-based payments for management, based on *fair value* at the grant date. [150] Swiss accounting only recognizes expense upon resource outflow, liability, or book loss. Treasury shares must be reported as a negative item in equity.[151] If such shares are given to employees, the tax authorities and EXPERTsuisse are not agreement on which accounting methods are correct or permissible.[152] In the case of the allocation of options, the situation is somewhat clearer: The creation of conditional capital does not give rise to any significant expense recognized in profit or loss. thus granted options don't require profit/loss recognition.[153]

VI. Outlook: What Reforms are Needed?

1. Employment Law Hinders Innovation Companies

Innovation thrives on flexible employment law. Swiss law must support Switzerland's innovative potential by focusing on its core purpose: protecting vulnerable employees and preventing excesses.

Rigid Federal Supreme Court case law, rather than the law itself, often hinders flexibility. Reclassifying bonuses as salary contradicts legal text. The CHF 400,000 salary protection limit disproportionately protects high earners; a lower limit might be socially more appropriate.

Furthermore, it should be permissible under employment law to pay a bonus for the achievement of clear measurable targets without having to pay this bonus even during the leave of absence. Current case law incentivizes formulating discretionary bonus targets, hindering performance-based incentives.

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[149] If the accounting standard requires the recognition of future tax credits (*deferred tax assets*), this may lead to additional fluctuations depending on the profit situation; see BARTHOLET/KURER, 352 f.

[150] BARTHOLET/KURER, 358; SCHOENBORN.

[151] Art. 959a para. 2 number 3 subs. e OR.

[152] Position EXPERTsuisse of December 1, 2017, Consultation on the Circular Letter "Tax Treatment of Employee Participations with the Employer", available at <https://www.expert-suisse.ch/mm/171201_AKS37A_Stellungnahme_EXPERTsuisse.pdf>; Position EXPERTsuisse on the Circular Letter no. 37A of the FTA - Conditions for the admissibility of liability and offsetting liberalization of 25 February, 2019, available at <https://www.expertsuisse.ch/dynasite.cfm?dsmid=519787&cmdbot=cnews_news_news_viewdet&id=2883&skipfurl=1>; BUCHMANN / HAAG / LOSER, 263

[153] BARTHOLET/KURER, 363; see also the materials above in footnote 160.

2. Tax Law Hinders Innovation Companies

Tax law also hinders innovation: the treatment of participation rights is excessively rigid, complex, and systematically flawed. Anyone who (voluntarily or involuntarily) defers remuneration with their employer as equity should not have to pay income tax on the accruing profit. The relief in the revised Circular No. 37, which provides for an acquisition at the formula value, is complex with an arbitrary and sometimes unclear valuation. The arbitrary five-year holding period (three years would suffice) hinders companies with faster innovation cycles. Valuation procedures lack clarity, creating unpredictable risks for all parties.

The simplest solution would be post-taxation on the sale of the shareholding on that part which is to be regarded as income at the time of allocation: Taxation of the fair market value at the time of allocation is deferred until realization. On the remaining part, the additional employee investment using non-taxed funds the reduced capital payment tax should be applied, analogous to a payment from the pension fund. Both capital gains are the result of a form of forced saving for employees and it is therefore appropriate to apply the same tax rules to them.

Alternatively, a simple rule taxing all employee equity proceeds as capital gains after a five-year holding period would be beneficial. Crucially, any adjustments must preserve the tax-free capital gains status for employees purchasing equity at fair value with taxed income, aligning their treatment with other investors.

VII. Summary

Motivated employees are crucial for innovation. While compensation is one motivational factor, growth companies (start-ups) often offer greater flexibility, diverse tasks, time autonomy, faster learning, and visible results. However, salary discrepancies compared to larger firms can be significant. Participation programs can help bridge this gap, but their structure is heavily influenced by tax regulations. Stock and option programs face complex corporate law regulations and strict employment law requirements impacting reversion clauses, vesting, and even share/option allocation. A robust, ideally majority-shareholder-supported process for establishing these programs is essential. [154] Existing employment law provisions already hinder innovation. Furthermore, simplifying complex tax rules for participation programs is crucial for Switzerland to remain attractive to innovative companies and their employees.

[154] BARTHOLET/KURER, 381 and 382.

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