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A quarterly review of current legal and tax developments in Germany

Greetings from the Editors

Dear Reader,

The beginning of 2012 marked the 10th anniversary of the day that Euro notes and coins replaced those of the member states. The Euro has been a tremendous driver for growth in the last decade. But one rescue package after another has cast serious doubts on the stability of the Eurozone.

In Brussels, European leaders agreed on a fiscal-discipline treaty with sanctions on high-deficit states and obligations to anchor balanced-budget rules in national law. The European Court of Justice will have jurisdiction to monitor compliance with the new rules. The developments in Greece – the Guardian called it 'Greek-style groundhog day' – have finally convinced the Eurozone members that bailing out another country must come with a central EU authority having power to directly intervene in national budgetary policies.

But the Brussels summit was not only about budgetary discipline as governments also passed a package in order to stimulate growth in the EU and to fight unemployment. The need to speed-up European harmonisation seems to be a key lesson from the Euro-crisis. An ambitious schedule lies ahead, to be completed in the near future, partly as early as the end of June 2012: Simplification of accounting requirements; advancing the use of e-commerce, e-signature, online dispute resolution and roaming; modernisation of Europe's copyright regime and reaching an agreement on the last outstanding issue in the patent package; making progress in the coordination of tax policy issues and the prevention of harmful tax practices; simplification of public procurement rules; and pushing ahead with the removal of trade barriers and ensuring better market access and investment conditions for European exporters and investors, in particular concluding trade agreements with major partners such as the US. Many of those tasks may not be easy to accomplish and will have considerable impact on the legal regime in the EU. The agenda for the next few months is impressive and we will keep you posted on the progress.

German business in the meantime continues to be very robust. Unemployment rates are at a record low and most other economic data remain positive. Some German politicians are struggling to survive though, most notably President Wulff who, for months now, is facing negative media coverage in what can be described as his personal financial crisis. So Germany after all has its groundhog days as well.

Best wishes,

Eike Fietz and Thomas Weidlich

On BaFin´s Watchlist: Do Not Become a Bank Without Banking License!

Recently a few venture capital and private equity investors had to face the special attention of the Federal Financial Supervisory Authority (*BaFin*) with respect to their capital participation agreements. If those agreements do not take into account specific supervisory requirements, the issuer of capital participations can be deemed a bank without banking license.

Whoever repeatedly provides capital to German companies through loans or mezzanine participations (e.g. participation rights – *Genussrechte* or silent partnerships – *Stille Gesellschaften*) without loss sharing is in risk to render banking services without a banking license and therefore may become liable to prosecution. In Germany, only approved banks are allowed to issue loans commercially. BaFin's strict view is that any issue of reimbursable capital to a German company may generally be deemed to be a loan, even if the lender has shares in that company. Only if the lender has the majority in a company, he is allowed to issue loans to that company. Therefore, any minority or mere capital investor should, together with its German legal advisors, check its capital participation agreements and whether they are in line with the recent and increasingly strict requirements of BaFin. As seen, the risk that BaFin may take enforcement measures has certainly increased. (MVA)

ESUG: On the Way to a New Insolvency Regime

German insolvency law faces material changes in favour of a more restructuring-oriented approach. Historically, German insolvency procedure was characterised by the strong influence of the administrator and the missing incentives for continuing operative functions of illiquid debtor companies. Since 2008, the credit crunch has shown the downside of such approach and resulted in major winding-up procedures instead of securing employment, know-how and operative units. The German parliament has responded to this and passed a law to make company restructurings easier ('*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen, ESUG*') in final hearings on 25 November 2011. The new law will presumably come into force on 1 March 2012. It is widely expected that the legal changes will lead to a more business and creditor friendly procedure of insolvencies under German law.

New Restructuring Phase Similar to "Chapter 11"

The introduction of a restructuring phase prior to the general insolvency procedure is strongly modelled after the English 'Scheme of Arrangement' and the US 'Chapter 11' procedures. Under such prior 'arrangement scheme', the debtor may continue its business and company under an enforcement-protecting umbrella for up to three months, provided that he early – at the stage of pending illiquidity – files for such proceeding. The continued business will be controlled by the insolvency court as well as a specially appointed restructuring expert ('*Sachwalter*').

Insolvency Plan Procedure Improved

Furthermore, the insolvency plan procedure has been improved. By an insolvency plan, creditors can develop together with the debtor and an administrator a specific plan by which the winding-up of the operating company is avoided and debts as well as the debtor company are restructured. By reducing red tape, the insolvency plan can be approved faster now. Furthermore, debt-to-equity-swaps are now expressly incorporated into German law and the influence of original shareholders in such exercise has decreased.

More Rights Given to Creditors

Another important change is the stronger influence of creditors on the election of the administrator and the strengthened possibilities to influence first proceedings during the preliminary insolvency proceedings by introducing a so-called 'preliminary creditors committee'. Subject to certain thresholds of the illiquid company (such as number of employees and turn-over of the last years), in future the preliminary creditors committee is mandatory and will monitor the preliminary administrator. (REW)

Damages for Antitrust Infringements

The German Federal Court of Justice (*BGH*) has held that indirect purchasers can bring antitrust damages claims to the courts *(BGH, 28 June 2011, KZR 75/10*). Thus, if producers agreed on a price fixing cartel and charged excessive prices, it is not only their contractual partners (e.g. wholesalers) who might be able to claim for compensation.

Rather anyone downstream (e.g. retailers) to whom the whole or a part of the overcharge has been passed onto now has standing. However, indirect purchasers bear the burden of proof as to the amount of the damage suffered and as to the causal link between this damage and the infringement of antitrust law. This may prove intrinsically difficult in practice, especially where the indirect purchaser has no real insight into the conduct on the market on which he purchases or on which the cartel infringement occurred.

Passing-on Defence

The second aspect clarified by the Federal Court of Justice concerns the so called passing-on defence. If a wholesaler sues a producer for damages the producer may claim that the wholesaler passed on the overcharges to his customers, the retailers, and thus the wholesaler has actually not suffered any damage. The court held that this is a valid argument that can be brought forward by the defendant. However, it is for the defendant to demonstrate that his customer has passed on the damage down to the next level of customers. In the end, the defendant has to prove, firstly, that the overcharge has been passed on by the defendant, secondly, the extent to which the overcharge has been passed on, and thirdly the causal link between the antitrust law infringement and the passing-on of the overcharge. This link might be missing, if the defendant was able to pass on the price increase due to his own business efforts.

The decision by the *BGH* facilitates the private enforcement of antitrust laws by allowing indirect customers to sue members of cartels. For the time being, practical problems might keep indirect customers from claiming damages. However, over the last years damages actions by direct customers have become increasingly common and the amounts at stake can easily exceed the amounts of fines imposed by the cartel authorities. It seems to be only a matter of time that professional claimants will collect claims of indirect customers to establish a new business model relating to this aspect – and will seek to test their business models on this aspect, too. (HEJ).

Revised German Temporary Employment Act (AÜG/ Arbeitnehmerüberlassungsgesetz) Imposes new License Requirements

On 1 December 2011 the legislative amendment regarding a change of the German Temporary Employment Act (‘*Arbeitnehmerüberlassungsgesetz, AÜG*’) came into effect (subtitled: ‘prevention of the abuse of temporary employment’). Against the background of an increasing number of temporary workers and in order to implement EU directive 2008/104/EC into German law, this legislative amendment aims to better protect temporary agency workers. Prior to the amendment only the “commercial” supply of temporary workers required a specific license. With the modification of the law it is now imperative to obtain a license as soon as the supply of the temporary workers takes place ‘within any economic activity’. Therefore, in particular public (state-owned), charitable and non-profit companies and organizations, which indeed do no ‘commercial’ business but only ‘economic activities’, now have to apply for a license to provide temporary workers. Many private companies will also be affected and should ensure to comply with this new requirement.

Severe Consequences in Case of Violations

This also applies to an intra-corporate provision of temporary workers (a supply within the group). The so called ‘*Konzernprivileg*’ (‘intra-group exemption’) granted by German law has been substantially restricted under the above mentioned European directive. Formerly, the supply of temporary workers within a group of companies was not subject to licensing, but this has changed now. To conclude, according to the new legislation nearly every supply of temporary workers requires a license. In case a company supplies temporary workers without seeking the required permission, the consequences are severe. The authorities may impose a fine up to EUR 25,000 per every (!) infringement. The management of the responsible company is personally liable for all fines. (KSU/ERU)

New Money Laundering Act Increases Obligations for Industry and Commerce

Mostly unrecognised from the general public the Federal Government (Federal Ministry for Finance) issued on 17 August 2011 the ‘Amended Proposal for a new Act for the Optimisation of the Money Laundering Prevention in Germany’ (‘*Entwurf eines Gesetzes zur Optimierung der Geldwäscheprävention*’). Most parts of the new law became effective at the beginning of 2012. The law will lead to substantial changes mostly of the existing Money Laundering Act (‘*Geldwäschegesetz, GwG*’) and other related Acts.

The proposal stipulates a number of substantial changes to the existing law especially by tightening obligations for industry and commerce with respect to anti-money laundering and financing terrorism compliance procedures.

Major changes are:

- Tightening of the duty to identify the beneficiary owner:
  Under the new law the beneficiary owner has to be identified and the correctness of the data has to be verified. This means that a copy of the passport or ID-card of the beneficiary owner is now necessary. Industry and commerce have to adopt compliance structures accordingly.

- Tightened announcement duties for industry and commerce:
  Any facts that may point to money laundering or financing of terrorism within the transaction / business / customer relationship now have to be dispatched to the responsible authorities. This also applies, if the customer / client refuses to comply with identification requirements. The barrier for the obligation to inform the authorities has been lowered substantially; compliance procedures have to be adapted to a tighter monitoring of the engagements. Any violation of this new obligation will now be fined with up to EUR 100,000.

- Cash transactions outside regular customer relationships:
  The threshold level for cash transactions outside of regular customer relationships has been lowered from EUR 15,000 to EUR 1,000. Under the new Act all cash transactions outside of regular customer relationships above of EUR 1,000 are now subject to identification and engagement monitoring procedures.

- New obligations to appoint money laundering officers:
  Casinos, financing-houses and entities acting in the trading of high-grade goods e.g. noble metal, airplanes, cars or ships are now required to appoint a money laundering officer. For all other professions the new Act authorises the relevant authorities to dispose the appointment of a money laundering officer. (SIG)

New Product Safety Law

Effective 1 December 2011, the Machine and Product Safety Act (‘*Geräte- und Produktsicherheitsgesetz*’) has been replaced by the new Product Safety Act (‘*Produktsicherheitsgesetz*’). In passing this new Act, the German legislative more than fulfils the requirements contained in the “New Legislative Framework”, which is intended to unify and simplify product safety laws within the European Union. For companies, this means stricter requirements and sanctions in the event of breach.

The new Act applies to all products. In other words, components would also have to fulfil the strict requirements contained in the Act, which originate to a large extent from the European CE-Regulations. The information accompanying the product, such as warning or safety instructions or instructions as to usage, will now play an even more significant role in the determination process whether a product is safe within the meaning of the Act. The new Act provides for measures, which can be taken against the sale of a particular product or against the distributor of that product. In particular, the new Act provides for increased supervision with regards to the use of CE-Marks. The wrongful use of CE-Marks results in strict sanctions, including but not limited to a significant monetary fine amounting to a maximum sum of EUR 100,000.

The new Act should also be considered together with German competition law. A breach of the requirements contained in the new Act would be deemed to be wrongful competition, which would enable other players in the market to enforce their legal rights afforded to them under German competition law. In practice, the number of such claims being made and enforced can be significant. (JHE)

Anti-Treaty-Shopping Rules Amended

Foreign entities holding shares in German corporations like an AG or a GmbH are completely or partially relieved from any withholding tax on dividends received on the basis of the applicable tax treaties or the EU parent-subsidiary-directive. However, under the current anti-abuse provision of the German Income Tax Act (ITA), such foreign entities can only benefit from these exemptions if certain requirements are met.

These include

a) existence of economic or other relevant reasons to interpose the foreign company as shareholder of the German entity in relation to the payments received;

b) the foreign company has with respect to its own business purpose adequate business substance to engage in general commerce; and

c) more than 10 % of the foreign company's gross income is derived from own business activities.

If these requirements are not met by the foreign company, the German tax authorities will examine the company's shareholding structure. A bottom-up review will be carried out and if a shareholder (at a level further up the corporate chain) meets all the conditions, then relief will be granted in relation to the portion of that shareholder's holding; if the shareholder is a resident of a non-treaty country, no relief from German withholding tax will be granted.

10 % Requirement

With respect to the 10 % requirement, pure holding companies should not qualify for the relief, as the mere administration of assets is not considered to be active business. The exemption will apply only if the holding company engages in the active management of more than one subsidiary.

If the 10 % threshold criterion is not met, a foreign parent company is fully excluded from a potential relief. For example, if a company derives only 9 % of the gross income from own active business activities, still such company would be disqualified. The anti-abuse provision does not allow any scope for submission of any proof to demonstrate that the structure in question is not abusive.

EU Commission Enforces Change to German Rules

Referring to this provision, the European Commission initiated an infringement proceeding against Germany on 18 March 2010 on the basis that the 10 % threshold was disproportionate. As a response to these infringement proceedings sec. 50d para. 3 ITA was amended by the "Law on the Implementation of the EU Mutual Assistance Directive and Other Changes in Tax Law" which has passed the German Bundestag in October 2011 and the German Bundesrat in November 2011 in order to make the provision compliant with EU law. This change has become effective on 1 January 2012. A decree providing administrative guidance for the tax office has been published by the Federal Ministry of Finance on 24 January 2012.

The amendment abolishes the requirement of the fixed 10 % income threshold. After the amendment a foreign entity may benefit from the double tax treaties or the parent-subsidiary-directive either (i) if and to the extent it generates income from own business activities, or (ii) if - in the absence of active income - the other criteria are met, i.e. there are economic or other substantial reasons for the establishment of the foreign entity and the entity participates in the general market with appropriately equipped business premises. This way the revised provision now allows for a (partial) relief for active income, even if the other requirements are not met, as well as for companies without any active income, provided that the two other criteria are met.

In addition to this, the benefit under provision of tax treaties or parent-subsidiary directive can also still be utilized, if the foreign company's shareholders qualify for the same; insofar there is no change to the current rule. According to the amended law, the foreign entity has the burden of proof to demonstrate the existence of economic or other relevant reasons and the adequate business substance.

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Practical Consequences

This amendment is of limited assistance for pure holding companies, unless they decide to engage in the active management of their subsidiaries, as holdings will often lack appropriately equipped business premises. Non-German companies holding German companies should analyze whether the amendment to sec. 50d para. 3 ITA can result in an extended refund. (PMS)

Protection of Buyers of GmbH-Shares by Conditions Precedent in SPA

A change in the law on German limited liability companies in 2008 increased the importance of the shareholders list of a German GmbH. The new provisions allow the bona fide acquisition of shares in a German GmbH, if a shareholder who is not holding proper title in the shares is registered in the company's shareholders list for at least three consecutive years, i.e. the good faith in a correct shareholder's list is protected.

Bona Fide (Secondary) Acquisition of Shares?

A shareholder, who has sold and transferred its shares in a German GmbH under certain conditions precedent does no longer hold a proper title in the shares, but is still registered in the shareholder's list of the company until the conditions are fulfilled. Thus, German jurisprudence discussed about the possibility of the seller to validly sell the same shares again to a third party, which relied on a bona fide transfer based on the shareholder's list ('secondary sale').

Notarial Caveats

Prior to a final decision of the German Federal Court of Justice (*Bundesgerichtshof, BGH*), certain measures were taken in order to prevent such secondary sales of the shares. Some notaries issued caveats with regard to the shareholder's list, either by directly referring to the sale under conditions precedent in a new, but identical list, or by issuing a note of objection (*Widerspruch*). Alternatively, a SPA may include a waiver of all conditions precedent in case the seller sells and transfers the shares a second time.

BGH: Secondary Sale and Transfer of Shares Not Valid

However, according to a recent ruling of the BGH dated 20 September 2011 these measures are no longer necessary. The BGH clearly outlined that the possibility to acquire shares bona fide from shareholders via a secondary sale during a period in which conditions precedent of the primary sale are not fulfilled is prohibited by German law. In future, the notarisation of the SPA (even with conditions precedent in place) gives sufficient protection to the buyer of shares in a German GmbH. (JFI)

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