Luther News, October 2012

German Law & Business News

A quarterly review of current legal and tax developments in Germany

Greetings from the Editor

Dear Reader,

Germany and Europe were able to breathe a sigh of relief last month after the German Federal Constitutional Court rejected a petition to stop the ratification of the permanent Euro rescue fund, the European Stability Mechanism (ESM). The conservative group *Mehr Demokratie* ("More Democracy"), together with 37,000 German citizens, applied for an interim court order alleging that Germany would thus commit to potentially unlimited and irreversible funding of debt-ridden Eurozone states. The court decision came with some conditions, though: ratification of the ESM Treaty had to ensure that under international law Germany's agreed liability cap of 190 billion euros (27% of the fund) may not be exceeded without the approval of the German representative in the ESM board and prior involvement of the federal parliament. This leaves open whether a vote of the whole German *Bundestag* or just from the smaller budget committee is required.

The ESM was announced in June and finally came into effect earlier this month. It will be equipped with 700 billion euro in capital and may lend up to 500 billion euro to support struggling member states, eventually replacing the European Financial Stability Facility (EFSF) set up last year. The decision by the highest German court and the announcement of the European Central Bank to buy government bonds of struggling countries ("Outright Monetary Transactions" program), if necessary without any limit, has bolstered stock markets around the world and strengthened the Euro. Many analysts suggest that Europe has made decisive steps in defusing its financial crisis.

European leaders – elated by the award of the Nobel Peace Prize to the European Union – continue with their efforts to bring back stability to the Eurozone. It does not lack a certain irony that the EU is honoured as a peace-making community, only days after German Chancellor Angela Merkel's state visit to Athens required heavy security. Merkel at least found conciliatory words when she expressed her confidence that Greece will eventually succeed with its painful reforms and stay in the Eurozone. And it looks as if the European Central Bank, the EU Commission and the IMF (the so-called "*Troika*") will also come to a positive verdict on the Greek government's reform process.

Germany in the meantime is watching the *troika* at the helm of the Social Democratic Party, the country's main opposition party. Former finance minister Peer Steinbrück is now the only remaining contender to run against Chancellor Merkel in the federal elections next year. Within hours of his nomination Steinbrück announced some controversial reform plans and it looks as if we have an interesting campaign ahead of us.

Best wishes,

Thomas Weidlich

EU Blue Card for qualified foreigners

The German Government wants to attract more qualified experts and has therefore decided to make it easier for foreigners to get a work permit though the EU Blue Card Germany ("Blue Card"). The new § 19a of the German Residence Act came into force on 1 August 2012 and alludes to skilled and highly qualified students and/or workers, who wish to tap a career opportunity in Germany.

To be allowed into the EU, applicants must produce:

a) a work contract or binding job offer with a salary of at least 1.5 times the average gross annual salary paid in the Member State concerned (Member States may lower the salary threshold to 1.2 for certain professions where there is a particular need for third-country workers, for example scientists, IT-experts, engineers and medical doctors);
b) a valid travel document and a valid residence permit or a national long-term visa;
c) proof of valid health insurance;
d) regulated professions - documents establishing the applicant meets the legal requirements; unregulated professions - documents establishing the relevant higher professional qualifications.

Current work permit holders can now get the *Niederlassungserlaubnis* (unlimited residence permit) after 3 years, and if the applicant speaks German (minimum requirement is certified level B1 German) it can be attainable already after 2 years, with a valid employment contract. Before the Blue Card, it was 5 years. In line with this, there is also the possibility to get a 6 month visa to search for a job in Germany, and foreign students have an 18 month time frame to look for a job after they have successfully concluded their studies, instead of the previous 12 months. (CLO)

German Corporate Governance Code revised: independence of supervisory members

The German Corporate Governance Code ("Code") has been amended with effect as of 15 June 2012. Particular attention has been paid to the independence of supervisory board members. The Code recommends inter alia that the supervisory board should include an appropriate number of independent members. A supervisory board member is not considered independent if he/she has personal or business relations with the company, its executive bodies, a controlling shareholder or an enterprise associated with the latter which may cause a substantial and not merely temporary conflict of interests. It is also recommended that the supervisory board shall specify concrete objectives for the number of its independent members in connection with its composition. Furthermore, the chairman of the supervisory board should not be the chairman of the audit committee.

The Code presents essential statutory regulations for the management and supervision of German listed companies and contains internationally and nationally recognized standards for good and responsible governance. The Code is not statutory law, but contains recommendations. Through the declaration of conformity (Sec. 161 of the German Stock Corporation Act ("*AktG*")) the code has a legal basis: the management board and supervisory board of a listed company shall declare annually that the recommendations of the Code have been and are complied with or which recommendations have not been or are not applied and why not ("comply of explain"). According to a recent decision of the German Federal Court of Justice (*BGH*), a discharge of the members of the management board and the supervisory board by the shareholders' meeting may be set aside if an incorrect declaration of conformity was issued. (MPE)

German Tax Bill

The Merkel government just has 12 months left before next year's elections. The latest Tax Bill includes some very important changes for international investors in Germany.

Taxation of Fiscal Groups (German Organschaft)

The German taxation of fiscal groups (the so-called *Organschaft)* is based on an agreement between the head of a fiscal group and its subsidiary which is a part of that fiscal group - the profit and loss absorption agreement. Fiscal groups have been challenged in many situations by the German fiscal authorities based on the exact required wording of this agreement. This caused tax leakage in many cases and tax contingencies and litigation in many others. In reference to article 302 of the Stock Corporation Act particularly, which says that the head of a group has to absorb losses, many uncertainties arose. The Tax Bill now requires that the profit and loss absorption agreement signed by a *GmbH,* which is a subsidiary in an *Organschaft*, must refer

to article 302 in its effective version, which in turn means that a change of this legal provision will indirectly also change the agreement due to the dynamic reference.

Fiscal groups were often not accepted by the tax authorities due to minor mistakes in the balance sheet, which resulted in an incorrect amount of profit or loss to be absorbed. According to the wording of the Tax Bill, those mistakes may not destroy the fiscal group anymore if the financial statements have been audited by a CPA and the mistake is corrected in the following year's balance sheet. Those amendments of the actual rules would apply retroactively for open cases and would help taxpayers whose tax groups failed to be accepted as long as the respective tax assessment notices are still open for change.

This is by far not what was announced as a reform of the *Organschaft* rules by the Merkel government when they started in 2007. At that time the agreement between the Christian Democrats and the Liberals for the election period was to modernize the rules on taxation of fiscal groups and to harmonize it with what the other EU countries have enacted. This intention had been confirmed early this year in the "12 Measures Program". This might mean that the big reform of the fiscal group taxation rules will not be enacted during this election period anymore. Anyhow it seems clear that implementation is not intended before 2016.

Loss Carry Backs

Loss carry backs are now limited to Euro 511,000. The Tax Bill intends to increase this amount to one million Euro, which would be a benefit for all taxpayers which are currently profitable and become loss-making in their fiscal year 2013 or thereafter. This measure is one of those listed in the 12 Measures Plan.

12 Measures Plan

The good news about this Tax Bill is that some very severe changes which have been listed in the "12 Measures Paper for Modernization and Simplification of the Business Tax System" have not been pushed forward. This plan was published by members of the parties forming the coalition for the federal government in February 2012. Especially private equity funds but also other investors who are looking for merger and acquisition opportunities in the German market have been worried that the deduction of interest expenses after M&A transactions through the debt-push-down models used by investors for many years would be disallowed. At least for now this seems to be off the agenda. (USI)

European Court: Ad-Hoc Notification in a staggered process ("*Daimler*")

German public companies listed on the regulated market must publish insider information immediately. However, it is sometimes difficult to assess at what time an information is already specific enough to be disclosed, in particular in case a transaction or another process involves several steps. The German Federal Court of Justice (*BGH*) presented to the European Court of Justice this question since it is considered to be of fundamental relevance when interpreting the regulations on insider trading, which are based on EU law. The case presented was the claim of a shareholder of Daimler AG, who argued that Daimler published too late the notification about the resignation of the former chairman of the management board, Jürgen Schrempp. Although the supervisory board had not yet formally decided on the resignation of Mr. Schrempp, the European Court came to the conclusion that already at the time Mr. Schrempp had informed the chairman of the supervisory board about his intention to resign, an ad-hoc notification should have been published since this information was already considered an insider information.

The ruling of the European Court shows that in any staggered transaction which might have an impact on the share price, each single step of the overall process must be analysed carefully to assess whether an ad-hoc notification requirement is triggered. This is, for example, also very relevant in complex M&A transactions. (PDI)

Obligation of a managing director to constantly observe the company's financial situation

In a recent decision, the German Federal Court of Justice (*BGH*) has ruled that the managing director of a German limited liability company (*GmbH*) is obligated to constantly observe the company's financial situation (*BGH*, 19 June 2012, II ZR 243/11). In this case the defendant was the sole managing director of a *GmbH* which filed for insolvency in November 2004. According to the liquidator (plaintiff), the company was already overindebted at the end of 2003. He argued that the

situation must have been known to the defendant and that the managing director is liable for any payments made in 2004.

Under German law, a managing director is generally liable to compensate the company for any payments made after the insolvency has occurred or the over-indebtedness is determined. The *BGH* ruled that there is an assumption that a managing director who executes payments whilst the company is in the aforementioned state has not acted with the necessary diligence. A managing director must at any time be able to prove that he had constantly observed the company's business and financial status. This includes the obligation to organize the internal communication in a way which always allows the managing director to overlook the situation of the company. In case of an upcoming crisis of the company, the managing director needs to constantly provide for a statement of assets and liabilities to obtain information on the current financial situation. If required the managing director must seek professional advice. (GRW)

The cross-border relocation of a German establishment to a foreign country can constitute a transfer of undertaking

Judgments on a cross-border transfer of undertaking ("TOU") are rare, but the German Federal Labor Court (*Bundesarbeitsgericht*, abbreviated "*BAG*") recently decided on such a case.

The plaintiff was employed with the defendant, a German subsidiary of an international company. Since the department in which the plaintiff worked should be closed, the employer terminated the contracts of the plaintiff and other employees in this department. That same day the plaintiff and some of his colleagues received an offer to enter into an employment contract with another group company in Switzerland which the plaintiff rejected. Subsequently, the defendant sold the department's equipment, machinery and inventory to the Swiss company, which also took over the customer lists and continued the production of existing orders. The customers were informed that their contracts had been taken over by the Swiss company. The plaintiff contested his dismissal with the argument that the department in which he was employed had not been closed but was the object of a transfer of undertaking, that this transfer constituted the ground for his dismissal and that therefore his dismissal was invalid and void pursuant to section 613a of the German Civil Code, which is the German transposition of the EU Acquired Rights Directive.

The *BAG* upheld the decisions of the lower instances and decided that the termination was invalid. It began by rejecting the defendant's argument that the termination of the plaintiff's employment was justified by operational reasons, namely the closure of the department in which the plaintiff worked. Since the employer did not stop the economic activity, but had sold it while retaining the entity's identity to another group company, the court found that this situation – the main tangible and intangible assets had been sold and the customer relations and production methods were continued – is qualified as a transfer of undertaking and not as a closure. The court held that the relatively short distance between both facilities (approximately 60 kilometres) did not prevent there being a transfer of undertaking.

Finally, the *BAG* decided whether this cross border transaction in question qualified as a closure or as a transfer of undertaking, was to be governed by German law since the place of work, as provided in the employment contract, was in Germany and the work had actually been performed in Germany. The fact that the assets were sold to a company outside Germany does not have any influence on this legal situation, even if it causes a transfer of undertaking, because the place of work does not change due to a change of the employing entity as the sole consequence of a transfer of undertaking is a succession in the employer position. In all other respects the employment contract remains as it is. Since from a German point of view the employer could not demonstrate that a closure of the establishment had occurred, the termination was declared void. (SPR)

Change of Legal Form within the EU ("*VALE*" and "*National Grid Indus*")

The European Court of Justice has once again decided in favour of European companies and ordered the Member States to observe the right of establishment as provided by Articles 49 and 54 Treaty on the Functioning of the European Union ("TFEU"). In its "*Sevic*" decision the European Court had already instructed Germany to interpret the German Transformation Act in a way to allow companies from other European countries to merge into a German legal form. Other important

judgments to be mentioned with regard to the right of establishment of European companies are, *inter alia,* "*Inspire Art*" and "*Cartesio*". The European Court now continues this jurisdiction in its recent "*VALE*" and "*National Grid Indus*" decisions.

The Italian company *VALE Costruzioni Srl* intended to move its seat to Hungary and operate there as *VALE Építési kft* in accordance with Hungarian law. The Italian commercial register removed VALE from the register with the note that the company had moved its seat to Hungary. After *VALE Építési kft* had been duly established, an application for entry in the Hungarian commercial register was filed together with a statement that all rights and obligations of *VALE Costruzioni Srl* as the legal predecessor of *VALE Építési kft* had been transferred to *VALE Építési kft*. The Budapest Metropolitan Court rejected the entry of *VALE Építési kft* in the commercial register on the grounds that an identity-maintaining conversion is only allowed for Hungarian companies.

The European Court came to the conclusion that Hungarian law infringes Articles 49 and 54 TFEU insofar as it does only allow the conversion of a domestic Hungarian company into a different Hungarian legal form but does not allow the conversion into a Hungarian legal form in a cross border situation. While the Member States are entitled to determine the national law applicable to transactions such as a conversion, they must comply with the principle of freedom of establishment and register a foreign company which has applied to convert as the predecessor in law, if such a registration is in principle allowed for domestic conversions. European companies are thus given the opportunity to choose the legal form and the country in which their business activities shall be performed if they meet all requirements determined by the Member States for domestic companies.

Although the Member States must in principle follow suit with the interpretations of the European Court, not all Member States actually observe this. In Germany (as in several other EU countries) for example, the tax legislation or practice actually deviates from the interpretation of the European Court. Traditionally, all hidden reserves are taxed immediately if a German company changes its legal form into that of another EU Member State as this is considered a liquidation of the company. In "*National Grid Indus*", the European Court ruled that this is not admissible anymore: the domestic tax authorities may only record the hidden reserves of a company in a cross-border transformation, but must impose tax strictly as in the domestic context, e.g. when the respective assets are sold. (KNE)

Imprint | Luther Rechtsanwaltsgesellschaft mbH, Anna-Schneider-Steig 22, D- 50678 Cologne, Germany, Telephone +49 221 9937 0, Facsimile +49 221 9937 110, contact@luther-lawfirm.com
Editor: Thomas Weidlich, Telephone +49 221 9937 16280, thomas.weidlich@luther-lawfirm.com
Regular contributors: Philipp Dietz (PDI), Katja Neumüller (KNE), Dr. Marc Peters (MPE), Dr. Gregor Wecker (GRW), Thomas Weidlich (TW) | Other authors: Carla Louise Olival (CLO), Stefanie Prehm (SPR), Ulrich Siegemund (USI)
Please contact the team for further information. All contact details can be found on our website www.luther-lawfirm.com.
