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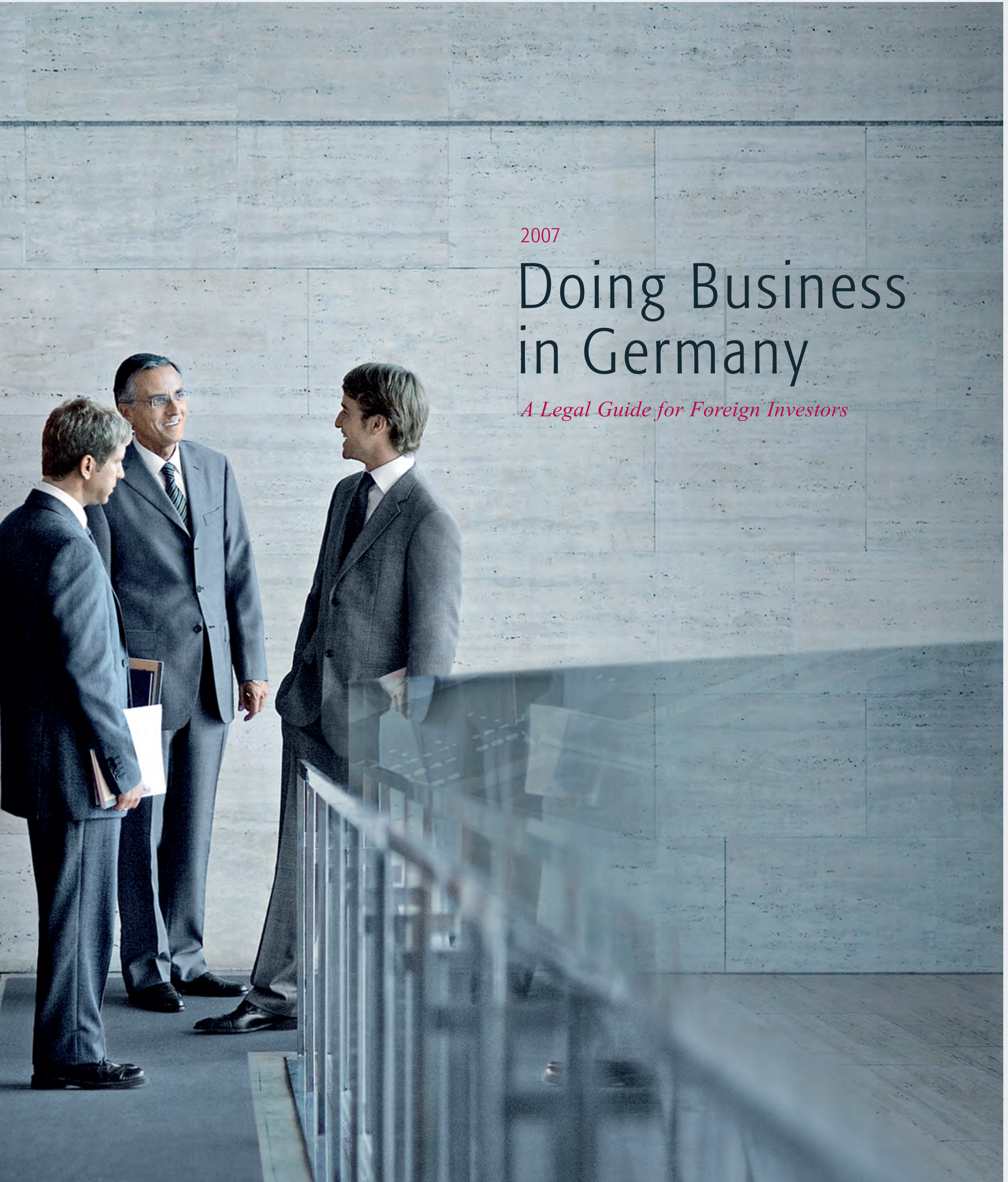

2007

Doing Business in Germany

A Legal Guide for Foreign Investors

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About us and this Legal Guide

Luther Rechtsanwaltsgesellschaft mbH is one of the leading law firms in Germany. We are well represented with 220 lawyers and have 13 offices in all the major German economic centers as well as in Brussels and Singapore.

Our professionals are highly qualified and experienced specialists in their respective area of expertise. This specialisation enables us to focus on the advice of specific industrial branches. All of the authors of the articles provided in this publication are lawyers at Luther. They have many years of professional experience and excellent know-how in their respective area of expertise.

Our clients include both medium-sized companies and major enterprises. Our law firm also enjoys an excellent reputation for its legal advice to municipalities and other public authorities.

Luther is able to provide interdisciplinary advisory services and to offer integrated and coordinated legal, tax, transaction and real estate advisory services in order to ensure the most suitable economic solution for our clients.

In addition, Luther is one of the founder members of the newly created law firm association Pinsent Masons Luther Group (PMLG) with more than 1,300 lawyers operating out of 33 offices in 13 countries across Europe and Asia. This network gives our lawyers access to fast and professional support for all cross-border issues and transactions.

Although in the preparation of this Guide, every effort has been made to offer current and correct information, this publication may only give general guidelines and cannot substitute individual legal or tax advice. This publication is distributed with the understanding that Luther cannot be held responsible for the results of any actions taken on the basis of information contained in this Guide, nor for any errors or omissions contained herein. Rather, companies doing business in Germany or planning to do so, are advised to obtain current and individual information and guidance.

This Guide reflects information current at the beginning of October 2006.

Additional copies of this Guide may be obtained from:

Luther Rechtsanwaltsgesellschaft mbH
Dr. Michael Rath
Brückenstraße 2
50667 Cologne, Germany
Telephone +49 (221) 9937 0
Telefax +49 (221) 9937 110
contact@luther-lawfirm.com
www.luther-lawfirm.com

Dear Reader!

*Why is **"Doing Business in Germany"** interesting enough that you should spend your valuable time in reading this Guide? The answer is simple, but convincing: The Federal Republic of Germany is the largest European economy and the third largest economy in the world in real terms, placed behind the United States and Japan. Furthermore, according to the World Trade Organization, Germany is currently the world's top exporter, ahead of the United States and China. Its major trading partners include France, the United States, the United Kingdom, Italy and the Netherlands.*

In addition, Germany ranks among the world's largest and most technologically advanced producers of iron, steel, cement, chemicals, machinery, motor vehicles, machine tools and electronics, as well as a world leader in the shipping business. Major car manufacturers like BMW, DaimlerChrysler (Mercedes), Opel, Porsche and Volkswagen AG (including Audi) are German. Germany is also proud of its huge multinational corporations like BASF, E.ON and Deutsche Telekom and its large presence in the banking world, led by Deutsche Bank and Allianz. Besides these "big tickets", Germany is home to a big number and variety of medium-sized businesses which form the heart of the German economy.

This Guide is intended to serve as an introduction to the legal and tax regime applicable while doing business in Germany. The basic principles outlined in this Guide give an idea of how many alternatives there are to efficiently structure a company with business seat in Germany. As an interdisciplinary law firm we have the legal and tax experts for all challenges connected with setting up business in Germany.

Please contact us, if you have any questions or comments. It will be our pleasure to assist you.

Yours sincerely,

Dr. Stefan Kraus
Managing Partner

Authors

Hans-Christian Ackermann
Martina Buhr
Guido Dornieden
Ingo Erberich
Dr. Michael Fritzsche
Franz-Rudolf Gross, LL.M. (London)
Dr. Hans-Georg Hahn
Dr. Stefanie Hellmich, LL.M. (Madrid)
Thomas Henßler
Stefan Hitter
Marcus Hotze
Dr. Helmut Janssen, LL.M. (London)
Dr. Eberhard Kalbfleisch
Dr. Thomas Kapp, LL.M. (UCLA)
Dr. Bernhardine Kleinhenz
Dr. Dirk Kleveman
Thomas Köhler
Thomas Leidereiter, LL.M. (Wales)
Achim Meier
Dr. Kay Oelschlägel
Dr. Matthias Orthwein, LL.M. (Boston)
Ulf-Dieter Pape
Dr. Michael Rath
Dr. Wulff-Axel Schmidt
Dr. Markus Sengpiel
Volker Steimle
Thomas Weidlich, LL.M. (Hull)
Reinhard Willemsen
Jutta Wittler
Dagmar Witzorrek
Dr. Angelika Yates

Editors

Hans-Christian Ackermann
Dr. Michael Rath
Dr. Marcel Klugmann

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Chapter 1

Legal Forms of Doing Business in Germany

by Thomas Weidlich, LL.M.; Dr. Angelika Yates

German law offers a broad variety of legal forms for conducting a business. All business vehicles are subject to registration requirements with the Commercial Register (Handelsregister) at the local District Court (Amtsgericht) of the place of operation of the business. The Commercial Register contains all basic information about the business and its owners. The Commercial Register is in the public domain and accessible to anybody, including creditors and public authorities.

Foreign individuals might start a business as a sole trader (Einzelkaufmann) or as a foreign entity via a German branch (Zweigniederlassung).

If the investor wants to set up an independent German business vehicle legally separated from its domestic business abroad, he has the choice between several types of partnerships (Personengesellschaften) as well as corporations (Kapitalgesellschaften). In the following chapters the different German business vehicles are briefly introduced to give an overview of their main features and to identify which vehicle might fit the individual needs of a potential investor.

Sole Tradership

For individuals, the sole trader (Einzelkaufmann) is the easiest way to start a business. The sole trader merely has to register his business with the Commercial Register. Furthermore, a notification to the local Trade Office (Gewerbeamt) is required. Unless a specially regulated business is carried out, there are no further requirements for starting the business. In some industries special approvals and permissions are mandatory.

The trader is also sole proprietor of all business assets and is also personally liable for all liabilities and debts deriving from the business. The profit resulting from the business is subject to German individual income tax.

A sole trader is subject to special provisions of the German Commercial Code (Handelsgesetzbuch, HGB) with regard to inter alia the conduct of the business, legal representation of the business, bookkeeping obligations, drawing up of financial statements and notification requirements.

Branch

Foreign companies not wishing to set up a new business vehicle or not yet sure about the sustainability of their engagement and commitment in Germany can simply carry on business in Germany directly and register as a branch (Zweigniederlassung) with the Commercial Register and with the local Trade Office of the municipality where the branch office is to be located.

Whereas the Trade Office only requests basic information about the branch name, its owner, representatives and type of business, the application for registration with the Commercial Register must also include details of the relevant foreign company, such as its legal form, place of incorporation, principal place of business, share capital and the names of its officers and directors. The application must be accompanied by certified copies of the certificate of incorporation and articles of association of the foreign corporation and must be signed by the directors of the foreign company who must also deposit a signature specimen with the Commercial Register. A notary public must certify the signatures of the directors. The registration procedure can be very time-consuming (especially where translations of the relevant documents are required).

A branch has no separate legal entity status and, therefore, is regarded as an integral part of the foreign company. It has to be kept in mind that a branch creates not only jurisdiction for the foreign company in Germany, but also a permanent establishment (Betriebsstätte) for tax purposes. The foreign company owns all assets and incurs all liabilities and debts deriving from the branch's operations. Consequently, the foreign company is also the contractual partner for customers and business partners of the German branch.

The choice between doing business in Germany through a branch or through a separate German legal entity is mostly tax-driven. Apart from tax considerations, a branch is the suitable business vehicle, if the business conducted in Germany will most likely have no substantial size and/or a long-term commitment in Germany is not wanted or is still uncertain. If a sustainable medium to long-term investment is sought, the investor should normally set up an independent German business vehicle.

Corporations

The German law provides for three major forms of corporations (Kapitalgesellschaften): The GmbH (Gesellschaft mit beschränkter Haftung – limited liability corporation), the AG (Aktiengesellschaft – stock corporation) and the rarely used KGaA (Kommanditgesellschaft auf Aktien – partnership limited by shares). Since October 2004, the investor can also use an European Company, Societas Europaea (SE), as a business vehicle in Germany.

GmbH

The GmbH (Gesellschaft mit beschränkter Haftung – limited liability corporation) is the corporate entity most commonly used by foreign investors in Germany. The structure of a GmbH is relatively straightforward and flexible. It is designed for closely held businesses (no IPO possible) with a clear and stable shareholder structure looking for full liability protection of its shareholders.

Advantages of a GmbH

The primary advantages of a GmbH compared with the other forms of corporations are as follows:

- The formation of a GmbH is quite simple;
- The articles of association (Gesellschaftsvertrag) of a GmbH can be easily adapted to the requirements of the shareholders; The GmbH is not subject to as many legislative regulations as an AG or the SE;
- The shareholders of a GmbH may issue binding instructons or directions to the Managing Directors and can thereby exercise direct influence on the GmbH's management.

Incorporation and Registration

A GmbH is formed by the founding shareholder(s) executing a deed of formation and articles of association before a German notary public. A GmbH must have at least one shareholder (but is not restricted to a maximum number). Foreign individuals, partnerships or corporations may become shareholders of a GmbH.
A representative of the founding shareholder(s) acting under power of attorney (which also must be certified by a notary public) may execute the deed of formation and the articles of association.

Immediately after notarization of the deed of formation and articles of association, but prior to filing the application for registration with the Commercial Register, the company must open a bank account. Cash contributions to the share capital must be deposited in said account prior to filing of the application for registration. In addition to other registration documents, the Commercial Register may request that bank statements be submitted to ensure that the cash contributions were in fact deposited into the company's bank account. The Managing Director(s) must certify to the Commercial Register that said cash contribution is still at the company's disposal, as of the date of filing of the application.

The application for the registration of a GmbH needs to be signed by all Managing Directors in person before a notary public, who must certify their signatures and instruct them about their duties as managing directors vis-à-vis the Commercial Register. The certifying notary may be a foreign notary, in which case, however, the notary's certificate must then be legalized by an apostille under the Hague Convention (if the country is a member of this convention), unless this requirement has been waived pursuant to a bilateral treaty.

Liability prior to Registration / Shelf Company

Upon notarization of the deed of formation and the articles of association the company exists as a so-called "Company in Formation" (Vorgesellschaft) and may commence business. However, only once the company has been registered with the Commercial Register does it become a separate legal entity.

Rights and liabilities arising from pre-registration activities are legally the rights and liabilities of the Company in Formation, but only to the extent that the Managing Director (s) are acting within the authority vested in them by the articles of association or by shareholders' resolutions. The Managing Director (s) remain jointly and severally liable together with the Company in Formation to creditors for liabilities incurred prior to registration of the GmbH with the Commercial Register. Upon registration of the GmbH, all rights and obligations acquired or incurred by the Managing Directors prior to registration are assigned by law to the GmbH and the personal liability of the Managing Directors expires at that time.

Although a GmbH may commence business prior to registration, its net assets, as of the date of registration, cannot be less than the amount of its registered share capital. Should this be the case (for example, as a result of losses incurred prior to the registration of the GmbH), the shareholders will be liable for the difference between the amount of the registered share capital and the net assets, as of the date of registration.

In order to avoid such liability without having to delay commencement of business until registration, investors frequently use a shelf company offered by commercial providers. However, due to a judgement of the German Federal High Court (Bundesgerichtshof) the commencement of the shelf company's business is treated in the same way as a new incorporation of the GmbH. Therefore, the above-mentioned issues regarding the pre-registration liability of the shareholders and the Managing Directors also apply. Consequently, the Managing Director(s) when filing the changes of the articles of association of the shelf company after its acquisition must disclose to the Commercial Register that it is actually the start of business of a shelf company. They also have to confirm explicitly that the registered share capital is still at the disposal of the company.

Limited Liability of Shareholders

Once registered in the Commercial Register, only the company itself is liable for its debts with its assets, including the share capital. The liability of the shareholders is limited to their capital contribution. Courts will look behind the company's separate legal entity and thereby pierce the "corporate veil" i.e., the limited liability status, only on very rare occasions. The mere fact that a shareholder is permanently and comprehensively controlling the GmbH will not result in the piercing of the corporate veil. A controlling shareholder will only be liable for a loss suffered by the GmbH if he or she acts contrary to the best interests of the GmbH and to the detriment of its creditors and does not respect the integrity and independence of the GmbH. In particular, a shareholder forfeits the protection of the limited liability shield if the shareholder intentionally abuses his controlling position to the disadvantage of the GmbH or its creditors.

Articles of Association

Depending on the degree of flexibility desired by the shareholders, the articles of association may be formulated in short form setting out only mandatory provisions regarding purpose, name, registered office, duration, registered share capital, initial contributions of each shareholder, representation and management of the corporation. The articles of association may, on the other hand, constitute a comprehensive document including detailed provisions on shareholders' rights and obligations, classes of shares and restrictions on the transfer of shares.

A GmbH may be formed for any lawful purpose which has to be stated in the articles of association. No doctrine of ultra vires exists under German law. A GmbH may therefore enter into binding obligations with third parties, which may not necessarily relate to its corporate purpose (in which case, however, the Managing Director(s) may be liable for damages caused by such obligations to the GmbH).

A GmbH may also use any name including fictional names provided that no risk exists of confusing the name with any other corporation within the same local area and that the name is not misleading. It should be noted, however, that registration officials remain cautious in the use of the words "International" and "Germany" in a corporation's name if no substantial international business actually exists or if the corporation only conducts local business rather than business throughout Germany.

German corporation law is federal law; from a legal perspective no changes therefore arise if the corporation is registered in a particular German state. Tax advantages may, however, arise if a GmbH is registered in a particular city because trade tax rates are determined by municipalities and consequently vary from location to location.

While a GmbH may only have one registered office, it may maintain any number of branches or offices throughout Germany. In case a branch (Zweigniederlassung) is set up, the branch has to be registered with the Commercial Register. The main registered office shall be the place where the GmbH operates its business or where its management is located. The registered office must be within Germany. If the GmbH should be actually operated and managed from abroad, there is, at least theoretically, the risk, that the GmbH could lose its status as a German legal entity. Consequences would be compulsory deletion of the GmbH from the Commercial Register triggering negative tax implications due to the liquidation taxation (taxation of all hidden reserves). Germany still maintains its "seat theory" which in fact prohibits relocating a German corporation's management to a foreign country despite the recent rulings of the European Court of Justice strengthening the freedom of movement of companies within the European Community.

Share Capital

The minimum share capital of a GmbH is € 25,000, divided into shares (Geschäftsanteile) that can have different nominal amounts. The minimum nominal value of the share of each shareholder must be at least € 100 and must be divisible by 50. Initially, each shareholder may only subscribe for one share. Additional shares may be acquired through a capital increase or if a share is acquired from another shareholder.

The GmbH is not required to issue share certificates or to maintain a share register, book or ledger, or to keep other formal records of share ownership. The ownership of the shares is documented only in the incorporation deed and any later transfers will be documented in notarial transfer deeds. Upon each transfer of shares the Managing Directors must submit up-dated shareholders' lists to the Commercial Register. However, such shareholders' lists are merely informational and do not provide any evidence of ownership of the shares.

Contribution and Maintenance of Capital

Contributions to share capital may be made in cash or in kind. For contributions in kind, the articles of association must set forth the specific form of the contribution as well as the amount of the corresponding share capital. The shareholders must provide a report on the valuation of the contribution in kind and, if the contribution in kind is a business to be transferred to the GmbH, the financial results of the business for the previous two years. The contribution in kind must ultimately be worth at least as much as the corresponding share capital. The shareholder must pay the difference in cash if this should not be the case.

In the case of a cash contribution, 50 per cent or € 12,500, of the share capital must be paid up in cash at the time of filing for registration of the GmbH, whichever is greater. If the GmbH only has one shareholder, security must be provided (in the form of, for example, a bank guarantee) for any unpaid capital. If the contribution occurs in kind, said contribution must be submitted in full.

The legislation governing the GmbH contains several provisions designed to ensure that the share capital of a GmbH is fully paid up and maintained. A GmbH is, in particular, not authorized to make any payments to shareholders, which would reduce the net assets of the corporation below the stated amount of its registered share capital. If payments are made to the shareholders violating the capital maintenance rules, the respective shareholders are obliged to repay the received contributions and the managing directors of the company, being responsible for the unlawful contributions, can be held liable for any damages sustained by the company.

Transfer of Shares

The transfer of a share in a GmbH requires a notarized transfer deed. The prior consent of the company is required if only part of a share (for example, € 20,000 of a € 50,000 share) is to be transferred. The articles of association may (and in the case of a GmbH with more than one shareholder will almost certainly) provide that other requirements must also be met (for example, consent of the other shareholders, pre-emption rights).

It is not yet decided, whether a foreign reorganization of the shareholder (like a merger) triggers the transfer of shares in a German GmbH automatically (i.e. by way of universal succession) or whether the German statutory formalities for the transaction have to be satisfied also in case of a foreign transaction.

Since there are no binding court rulings available and the law does not provide sufficient guidance, it is recommended, before implementing a foreign re-organization that has an impact on the shareholder structure of a GmbH, to have the GmbH shares transferred by way of a notarized transfer deed prior to the implementation of the reorganization abroad.

Managing Directors

A GmbH is managed and legally represented by its Managing Director(s) (Geschäftsführer). A GmbH must have at least one Managing Director and can have as many as wanted. A Managing Director does not need to be a shareholder or a German resident (regarding the immigration procedures of a non-EU resident, please refer to chapter "Visiting, Living and Working in Germany"). Only an individual (and not a corporate entity) may, however, be appointed as Managing Director.

Absent any restrictions, each appointed Managing Director may act for and bind the GmbH vis-à-vis third parties. Any restrictions on the authority of the Managing Director(s) to bind the GmbH which are set forth in the articles of association, in a shareholders' resolution or in the service contract of the Managing Director (in particular any requirement to obtain the prior approval of the shareholders for certain transactions) do not affect the Managing

Director's ability to bind the GmbH. The breach by the Managing Director of any of the aforementioned may, however, give rise to a claim for damages by the GmbH against the Managing Director.

If one Managing Director is appointed, he/she is the sole representative of the GmbH. If more than one Managing Director is appointed, generally, they represent the company jointly. The shareholders may, however, grant one or several Managing Directors the right to either: (i) represent the GmbH individually; or, (ii) represent the GmbH jointly with one or more other Managing Directors or Authorized Officer (Prokurist), a representative of the company with a general power of attorney. The power of representation of each Managing Director is registered with the Commercial Register and is binding in relation to third parties.

The Managing Directors must manage the company's business with the due care of a prudent business person. Additional specific obligations may be imposed by the articles of association or the service contract or in shareholders' resolutions. Further, the shareholders – acting by a bare majority – can give binding instructions to the Managing Directors which they have to obey unconditionally unless the instructions are unlawful.

Managing Directors who are in breach of their duties are jointly and severally liable to the company for any damages sustained. In particular, Managing Director(s):

- May not disclose trade secrets of the GmbH;
- Must file for bankruptcy if the GmbH is over-indebted;
- Must call a Shareholders' Meeting if more than half of the share capital is lost;
- Must ensure that the GmbH keeps proper records.

Supervisory Board

A GmbH may voluntarily establish a supervisory board consisting of "non-executive" members. However, if a GmbH has more than 500 employees the installation of a supervisory board is mandatory and 1/3 of its members must be employees' representatives. If the number of employees of the company exceeds 2000, half of the members of the supervisory board must be employees' representatives. In case of the voluntary establishment of a Supervisory Board, the functions of the Supervisory Board may be stipulated in the articles of association.

The basic function of the supervisory board is to supervise the management of the company and it may also be assigned the right of appointment and removal of the managing directors, adoption of the annual financial statements and calling of shareholders' meetings.

Shareholders

The shareholders' of a GmbH are subject to various rights and duties. The most important of which are as follows:

- Voting rights;
- The right to participate in the profits of the company;
- Rights to any surplus upon liquidation;
- The right to obtain information.

The shareholders exercise their powers by passing resolutions in general meeting (or by circular resolution). A shareholder will generally have one vote per € 50.00 of share capital. The articles of association may, however, provide otherwise. Shareholders' resolutions require a simple or bare majority (i.e., more than 50 per cent of the votes cast) unless mandatory law or the articles of association require a greater majority or the consent of certain shareholders. For example:

Amendments to the articles of association require a special majority (75 per cent of the votes cast). This majority requirement may only be increased and not decreased by the articles of association. German law requires the consent of certain shareholders, or indeed all of them, when the obligations of some or all of the shareholders are to be increased such that said action is only possible with the consent of all affected shareholders. This would include the obligation to provide funds to the GmbH. The consent of the affected shareholders, plus a 75 per cent majority of all votes cast is required in this case. The articles of association, however, may provide otherwise. All shareholders of a GmbH must be treated equally. As ruled by the courts, the principle of equal treatment provides that no shareholder may arbitrarily be subjected to unequal treatment by the company or by any other shareholder without his/her consent. An example of unequal treatment would be a resolution providing that only certain, rather than all, shareholders may subscribe to an increase of the registered share capital.

The shareholders have a claim to the profits stated in the annual financial statements of the company in proportion to their shareholding, unless the articles of association provide otherwise. Shareholders have the right to inspect the books and records of the GmbH and to be informed by the Managing Director of the GmbH's affairs. This right may be restricted by a shareholders' resolution passed by simple majority under certain circumstances, in particular if a shareholder uses information for improper purposes. Each shareholder owes a duty of loyalty to the company as well as to the other shareholders. This does not mean, however, that the shareholder should place the interests of the GmbH above his/her own in each case, but it does place some limits on the extent to which the shareholder may pursue his/her own interests to the detriment of the company.

Ongoing Accounting Obligations and Disclosure Requirements

A GmbH must keep accounting records and prepare annual financial statements in accordance with the provisions of the German Commercial Code (HGB) which lay down detailed requirements as to the form and content of the annual financial statements. Furthermore, medium-sized and large corporations must have their annual financial statements audited. The (audited) annual financial statements must be filed with the commercial register within twelve months of the end of each financial year.

However, German corporations are not obliged to lodge annual returns with the commercial register. Only actual changes relating to the registered information (e. g. registered office, articles of association, registered shares capital, etc.) must be notified.

Pending Reform of the GmbH Law

The German Ministry of Justice is proposing a quite substantial overhaul of the Limited Liability Companies Act (GmbH Act). The first draft of suggested amendments to the GmbH Act was released on May 29, 2006 and pursues the objective to simplify the incorporation and regulation of the GmbH in order to enhance its competitiveness within Europe. One of the major changes envisaged is the reduction of the minimum share capital from € 25,000 to € 10,000. Another significant suggestion is that, in the future, a purchaser of shares in a GmbH may rely on the shareholders' list filed with the commercial register, thus acquiring title in the shares in good faith from the person(s) stated therein. Furthermore, if the proposed changes are implemented, the management and place of business of a GmbH may be permanently expatriated to another EU member state. The amendments to the GmbH Act shall come into effect by the end of 2007.

AG

The stock corporation AG (Aktiengesellschaft) is the corporate form adopted by many of Germany's largest corporations and the vast majority of the listed companies. It is also used by some of the major publicly held US corporations for their German subsidiaries, for example Opel AG (German subsidiary of General Motors), Ford AG (German subsidiary of Ford) and Esso AG (German subsidiary of Exxon).

Advantages of an AG

The AG is the German legal form which is comparable to public companies in Anglo-Saxon jurisdictions. The principal advantage of an AG is that, unlike a GmbH, the shares of an AG may be transferred with relative ease and that the AG can be listed on a stock exchange. Capital may therefore be raised from the public. However, some closely held businesses have also adopted this corporate form due to the arguably higher market reputation of an AG and the fact that the management is not bound by shareholders' directions.

An AG is subject to extensive legislative regulations. Because most of these regulations constitute mandatory law, little flexibility exists to adapt the articles of association to specific shareholder requirements. Certain standards with regard to the articles of association of listed AGs have also developed in practice, which should be adopted if an AG subsequently considers becoming listed on a stock exchange.

Another important feature of an AG is the independence of the Management Board with regard to managing the AG. In particular, the members of the Management Board are appointed by the Supervisory Board (which is mandatory for an AG) rather than by the shareholders. In addition, and in contrast to a GmbH, neither the shareholders nor the Supervisory Board may issue binding directions to the Management Board. Furthermore, the members of the Management Board can only be dismissed during the term of their office for good cause. As a result, neither the shareholders nor the Supervisory Board have direct influence on the management of the AG.

Incorporation and Registration

An AG may be established by one or several shareholders. The formation procedure of an AG is similar to that of a GmbH. In particular, it requires notarization of the articles of association and subscription for the initial shares by its founding shareholder(s). The founding shareholder(s) then must appoint the first Supervisory Board and the first auditor of the company. Such appointments must be notarized. The first Supervisory Board appoints the first Management Board. The founding shareholder(s) must prepare a written formation report which must state all relevant

details concerning the establishment of the AG. The Management Board and Supervisory Board will scrutinise the foundation procedure and under particular circumstances (e.g. where members of the Management Board or the Supervisory Board are taking up shares or where shares are issued against contributions in kind) the formation report must be audited by an independent auditor. The formation of the AG must be registered with the Commercial Register. The application for registration must be signed before a notary public by all founding shareholders, as well as by the initial members of the Management Board and the Supervisory Board. Upon registration the AG exists as a separate legal entity. Persons acting for and on behalf of the AG prior to registration will be personally liable for any debts incurred.

Limited Liability of Shareholders

As is the case with the GmbH, upon registration with the Commercial Register, only the AG will be liable for its debts with its own assets, including its share capital whereas the liability of its shareholders is limited to their respective capital contribution. Arguably, the principles developed by the courts with respect to piercing the corporate veil would also apply to the AG. However, since the shareholders do not have the same power of influence on the management of the company such cases rarely happen in practice.

Articles of Association

The minimum contents of the articles of association are prescribed by the German Stock Corporation Act (Aktiengesetz, AktG) which regulates the AG and include:

- Company’s name and registered seat;
- Object of the company;
- Amount and division of the company’s share capital;
- Type of shares (bearer shares or registered shares);
- Number of the members of the Management Board or the rules for determining such number.

The articles of association may regulate other issues but may only deviate from the provisions of the AktG where this is expressly permitted. Since only few and limited deviations are permissible, there is very little flexibility in drafting the articles of association of an AG.

Share Capital

An AG must have a minimum share capital of € 50,000. Shares may be issued either with a par value (Nennbetragsaktien) of at least € 1.00 per share or multiples thereof or without a par value (Stückaktien). A shareholder may hold more than one share. German law further distinguishes between bearer shares (i.e., shares where the name of the owner is not registered in the share register of the AG – bearer shares are the vast majority) and registered shares (i.e., where the name of the owner has been registered in the AG’s share register – registered shares are rather rare). The articles of association must specify the type of shares that may be issued. Bearer shares may not be issued unless they are fully paid in.

The transferability of bearer shares may not be restricted, whereas the articles of association may provide that registered shares may only be transferred with the consent of the Management Board.

Furthermore, shares may be issued as ordinary shares or as preferred shares (similar to but not identical with “preference shares” in many common law jurisdictions); the latter may be issued with or without voting rights.

The holders of preferred shares are entitled to preferred dividends, usually calculated as a fixed percentage of the nominal value of the preferred shares (a mere link to the annual profits earned by the AG shall not be allowed). Shares with multiple voting rights are not permitted.

Contribution and Maintenance of Capital

Contributions to share capital may be made in cash or, if permitted by the articles of association, also in kind. As with a GmbH, the value of a non-cash contribution must be at least equal to the share capital to which it relates. Certain procedures must be followed in order to safeguard this principle (i.e., formation report of the founding shareholders, audit of the formation report by an auditor, examination by the courts). Contributions in kind must be fully made upon incorporation. However, if the contribution in kind consists in the transfer of a particular asset, such transfer must be made within five years after registration of the AG with the Commercial Register.

If shares are issued for cash, at least 25 per cent of the par value of each share (plus the full amount of any premium) must be paid up prior to filing for registration of the AG with the Commercial Register. If the AG only has one shareholder, security must be provided for the outstanding payments. Demands for outstanding payments are issued by the Management Board.

As with a GmbH, the legislation governing an AG is designed to ensure that share capital is paid up and maintained. The rules applying to an AG are in fact even stricter in this respect.
Contributions may, in particular, not be repaid to shareholders, irrespective of whether this would reduce the net assets of the AG below its registered share capital.

Transfer of Shares

Shares in an AG are transferable with relative ease. Unlike the transfer of shares in a GmbH, a transfer of shares in an AG does not require the execution of a notarized transfer deed. Restrictions on the transfer of registered shares (but not on the transfer of bearer shares) may be imposed by the articles of association.

Notification Requirements

Any direct or indirect shareholding in an unlisted AG exceeding 25 per cent of the registered share capital must be notified by the relevant shareholder to the AG in writing. The same notification requirement applies again if the shareholding exceeds 50 per cent of the registered share capital or the voting rights. Without proper notification, the shareholder rights pertaining to such shares are suspended. If the shareholding falls below these threshold values, the same notification requirements apply.

In the case of a listed AG, the shareholders must notify any direct or indirect shareholding exceeding (or falling below) 5, 10, 25, 50 or 75 per cent of the voting rights to the AG and the authority supervising listed entities (Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin).

Management Board

The Management Board bears the sole responsibility for managing the AG. In contrast to a GmbH, neither the shareholders nor the Supervisory Board Members may issue binding directions to the Management Board regarding the management of the AG. Stock Corporations with more than € 3 million in capital must have a Management Board of at least two persons, unless the articles of association provide otherwise. Only individuals may be appointed to the Management Board.

An AG with more than 2,000 employees must have a Chief Personnel Director (Arbeitsdirektor) as a member of the Management Board holding responsibility for employment and social affairs.

Members of the Management Board are appointed by the Supervisory Board. Shareholders may not direct the Supervisory Board as to whom should be appointed as member of the Management Board. Shareholders' agreements on the composition of the Management Board are therefore not enforceable. In practice, however, informal consultations usually occur between the Supervisory Board and the majority shareholder(s) regarding the appointment of the members of the Management Board and usually the Supervisory Board will only appoint members who are acceptable to majority shareholder(s). Members of the Management Board are appointed for a maximum term of five years (which can be renewed, however, for additional periods of up to five years). Once such an appointment is made, however, it can only be revoked for good cause by a resolution of the Supervisory Board.

The manner in which the members of the Management Board may legally represent the AG must be expressly set forth in the articles of association (individually, jointly, etc.). The powers of the Members of the Management Board may be limited by the articles of association or by the Supervisory Board by stipulating that certain acts require the consent of the Supervisory Board or the shareholders in general meeting. Such limitations do not, however, affect the validity of the actions of the Management Board vis-à vis third parties.

The members of the Management Board must apply the due care of a prudent and conscientious manager in managing the company. If they breach their duties, the members of the Management Board are jointly and severally liable for any damages sustained by the company. The liability of the members of the Management Board imposed under the AktG is quite strict. In particular, the burden of proof lies with the members of the Management Board who must proof that they complied with their duties. However, the so called "business judgement rule" applies which means that the members of the Management Board are not liable where they could reasonably assume (based on an appropriate level of information) that they were acting in the best interests of the company. This concept was developed by the courts and is now written in statute.

Supervisory Board

An AG must have a Supervisory Board. If the AG has over 500 (but less than 2,000) employees or if the AG has less than 500 employees but was registered in the Commercial Register prior to August 10, 1994 and is not family-owned, 1/3 of the members of the Supervisory Board must be employees' representatives. If the AG has more than 2,000 employees, half of the members of the Supervisory Board must be employees' representatives.

The function of the Supervisory Board is to supervise and advise the Management Board. If there are no employees' representatives on the Supervisory Board, all members of the Supervisory Board are appointed by a simple majority vote of the shareholders, unless the articles of association provide that a particular shareholder may appoint one or more members of the Supervisory Board. If the AG has more than 2,000 employees (with 50 % of the members of the Supervisory Board being employees' representatives), the Chairman of the Supervisory Board who is elected by the members of the Supervisory Board, has a casting vote in the event of a tie. The voting procedure set forth in the relevant legislation is designed in such a way that the Chairman may not be elected against the wishes of the shareholders' representatives on the Supervisory Board.

This procedure, together with the Chairman's casting vote, ensures that the ultimate decisions of the Supervisory Board rest with the shareholders' representatives. Members of the Supervisory Board are appointed for a maximum term of five years.

Members of the Supervisory Board may be dismissed:

- By a court ruling, for good cause, upon the initiative of the other members of the Supervisory Board;
- By a 75 per cent majority of votes in a General Meeting (only applies to shareholders' representatives);
- By the appointing shareholder, if a specific right to appoint existed in the articles of association (only applies to the representative of the appointing shareholder).

The main functions of the Supervisory Board are as follows:

- Appointment and dismissal of the members of the Management Board;
- Supervision of the Management Board, involving the examination of both legal and commercial aspects of Management Board actions;
- Representation of the AG in its dealings with the Management Board;
- Representation of the AG (together with the Management Board) in litigation relating to the validity of shareholders' resolutions;
- Consent to major business decisions of the Management Board if required by the articles of association or by the Supervisory Board (e.g. by internal rules of the Management Board issued by the Supervisory Board or by individual resolutions on a case by case basis);
- Retaining of the statutory auditor, review and approval of the annual financial statements.

The members of the Supervisory Board must apply the same due care as the members of the Management Board and in case of a breach of their duties may also be liable for any damages sustained by the company. In particular, the members of the Supervisory Board must not disclose any confidential information regarding the company and its affairs.

Shareholders

The shareholders of the AG exercise their powers by passing shareholders' resolutions in general meeting. Generally, an AG holds a general meeting within the first eight months after the end of every financial year to conduct routine business. During such annual general meeting the annual financial statements of the previous financial year will be laid before the shareholders and the shareholders will pass resolutions relating to dividend payments and the exoneration of the members of the Management Board and the Supervisory Board with respect to their actions in the previous financial year.

The Management Board is entitled (and in certain cases obliged to) convene general meetings, although the Supervisory Board may also call general meetings in certain circumstances. Furthermore, shareholders holding at least five per cent of the registered share capital may require the convocation of a shareholders' meeting. The articles of association may, in addition, grant the power to call general meetings to other persons, for example, to majority shareholders. The calling of a general meeting of an AG is subject to quite onerous notice requirements.

Shareholders' resolutions require a simple majority (more than 50 per cent of the votes cast) unless mandatory law or the articles of association require a greater majority. For example, a 75 per cent majority of the votes cast is required for any amendments to the articles of association, increases or decreases in share capital, control agreements with other companies (i.e., agreements whereby a corporation submits itself to the control of another or agrees to transfer its profits), the transfer of all assets and the change of corporate form. Furthermore, the AktG requires the consent of certain shareholders whenever their rights are affected by certain measures of the company.

As mentioned before, the shareholders decide on the distribution of profits in general meeting. Profit distributions in kind (Sachausschüttungen) are allowed as far as explicitly permitted in the articles of association. The shareholders are, however, bound by the annual financial statements prepared by the Management Board and approved by the Supervisory Board; such decisions may therefore not deviate from the profits stated in said financial statements.

In making their decisions, shareholders of an AG have a duty of loyalty to the company, but not to the other shareholders. Similar to a GmbH, the shareholders of an AG must be treated equally under equal circumstances.

Ongoing Accounting Obligations and Disclosure Requirements

An AG must keep accounting records and prepare annual financial statements in accordance with the provisions of the German Commercial Code which lay down detailed requirements as to the form and content of the annual financial statements. Furthermore, medium-sized and large corporations must have their annual financial statements audited. The (audited) annual financial statements must be filed with the commercial register within twelve month of each financial year.

However, German corporations are not obliged to lodge annual returns with the Commercial Register. Only actual changes relating to the registered information (e. g. registered office, articles of association, registered shares capital etc) must be notified.

KGaA

The partnership limited by shares KGaA (Kommanditgesellschaft auf Aktien) is a form of a corporation that is not used very often in Germany. The KGaA is a hybrid structure that combines structures of a limited partnership and an AG. This Partnership must have at least one general partner, who is personally liable for all debts and liabilities of the KGaA. Corporations with limited liability can act as the general partner of a KGaA and thereby achieve a full liability shield when forming e.g. a GmbH & Co. KGaA (similar to the very popular partnership structure GmbH & Co KG). Apart from the general partner, there can be an unlimited number of capital investors (Kommanditaktionäre or limited shareholders) who hold shares in the KGaA. The capital investors similar as shareholders of an AG are protected from any personal liability, if they have properly paid in their subscribed capital contribution. A general partner can be a capital investor at the same time.

Although legally treated like an AG and, therefore, a corporation with separate legal entity status, the internal management of a KGaA is more comparable to that of a KG (i.e. a limited partnership). The provisions governing the KG in particular also apply to the relationship between the general partner(s) and the limited shareholders and to the representation of the KGaA vis-à-vis third parties. This means that, the KGaA is managed and legally represented by the general partner(s), who are personally liable for all debts and liabilities of the KGaA. The capital investors have more or less the same legal rights and obligations as shareholders in an AG.

The shares are freely transferable and a public listing is possible. Due to this extraordinary hybrid structure and the lack of precise legal provisions regarding its internal management, a potential investor willing to choose the KGaA as a investment vehicle will most likely face some difficulties (but also certain advantages) when compared to the traditionally used forms of corporations. Furthermore, due to the limited number of corporations in the form of a KGaA only very limited court rulings dealing with the KGaA exist, leaving legal uncertainties.

A KGaA can either be set up by new incorporation or by transforming existing entities into a KGaA. Whereas incorporation requires at least five founders (but only for incorporation purposes), an existing entity with only one shareholder or owner can be transformed into a KGaA, owned by only one person (being the sole general partner and the sole capital investor at the same time). This peculiarity is the result of an omission of the legislature, which overlooked to change the respective provision of the Stock Corporations Act for the KGaA when allowing the sole shareholder incorporation of the AG. Therefore, the transformation might be the more appealing way to set up a KGaA structure.

A KGaA has the same ongoing accounting and disclosure obligations as an AG. Any investor contemplating the legal form of a KGaA for its investment should be aware that this rarely used form will not only trigger additional incorporation costs but also higher costs for tax compliance. Therefore, the KGaA might only be considered as the appropriate vehicle to carry on business, if

- Capital investors shall be attracted via public offerings, but the control rights of shareholders in an AG shall be avoided
- The KGaA is the appropriate form to achieve a preferred tax treatment (e.g. acquisition scenario)

European Company

Since December 2004, the European Company, also called Societas Europaea or "SE", can be used as a legal entity when setting up business in Germany. The provisions that govern the SE in Germany are based on an EU Regulation that has been implemented by German national law. Even though the provisions of the EU Regulation directly and primarily apply to the SE in each of the EU member states, the EU Regulation left some room for the EU member states to adopt supplemental legislation. Accordingly, there are different legal models of the SE in the respective European jurisdictions, and for foreign investors planning to invest in Europe via a SE, it will make a difference in which member state the SE is incorporated.

The features of a German SE are very similar to those of an AG. Like any SE, also the German SE must have a link to at least two member states of the EU. Therefore, a mere German business operation cannot be conducted through a SE.

Formation and Registration

The German SE can only be formed by one of the following four ways:

- Merger of two or more existing stock corporations (including existing SE) based in different EU member states into a newly formed SE;
- By at least two existing corporations (including existing SE) based in different EU member states setting up a holding SE;
- By at least two existing corporations (including existing SE) based in different EU member states forming a subsidiary SE; or
- Transforming an existing stock corporation based in a EU member state into a SE (the existing stock corporation must have a subsidiary in a different EU member state for at least two years).

Upon formation the SE must be registered with the relevant Commercial Register.

Minimum Share Capital

The SE must have a minimum share capital of € 120,000. Unlike other German corporations, the SE is entitled to relocate not only its principal place of management, but also its registered office to another EU member state. The leaves a degree of flexibility for future developments and could be one of the main reasons for choosing a SE.

Management

The major difference with respect to the internal structure of a German SE and an AG is that the German SE may choose to have a one-tier board system (Administration Board) instead of the otherwise mandatory two-tier board system of an AG (Management Board and Supervisory Board). As a result, the German SE may opt to have only one administrative body that is responsible for the management of the company. The German legislation provides that the (one-tier) Administration Board may appoint certain persons who will be responsible for the day to day business and the management of the SE including its legal representation. Such persons may or may not be members of the Administration Board. This means that the Administration Board of a German SA may consist of executive and non-executive members, which is very similar to the one-tier board system in Anglo-Saxon jurisdictions.

With respect to a participation of employees' representatives on the Supervisory Board or Administration Board the EU Regulation does not stipulate specific requirements but rather provides for a complex negotiation model. In a nutshell, a negotiation committee consisting of employees' representatives and representatives of the company's Management Board or Administration Board must negotiate in good faith in order to reach a decision on whether or not employees' representatives will be included in the administration of the SE. In case no agreement can be reached, the provisions that apply to the AG will also apply to the German SE.

Whether the German SE will become a popular choice of legal form for foreign investment remains to be seen. The fact that the German SE is based on the very complex and comprehensively regulated AG and that it can only be set up in one of the prescribed four ways and if certain prerequisites are met, will most likely limit the use of this new model.

Nevertheless, leading German insurer, Allianz AG, was the first large corporation in Germany to incorporate a "German SE" by merging with its Italian affiliate Riunione Adriatica di Sicuritá (RAS) S.p.A. in September 2005.

Using European Corporations for Business in Germany

Due to some recent court rulings of the European Court of Justice (and subsequent rulings of the German Federal High Court) it is also possible for foreign corporations incorporated in a member state of the EU to relocate their principal place of management, immediately after their incorporation, to Germany provided that the respective EU jurisdiction allows and respects the expatriation of the corporation.

For instance, a UK company with limited liability duly incorporated and registered in England with a pure German management

located in Germany will be recognised as a corporation in Germany and is allowed to carry on its business from and in Germany without facing any restrictions. With respect to companies incorporated in the State of Delaware in the USA, which relocate to Germany, the same principles apply (based on a German American bilateral agreement).

Whether a foreign (shelf) company is a feasible alternative to a German corporation to set up business in Germany depends on various aspects that should be carefully considered. Apart from the question of the acceptance by German customers and the reputation in the market, the tax and accounting implications must be assessed especially closely.

Partnerships

Partnerships (Personengesellschaften) are available as

- General partnership: oHG (offene Handelsgesellschaft) and
- Limited partnership: KG (Kommanditgesellschaft).

The only major difference between the two forms is the liability of its partners. While all partners of an oHG face unlimited liability for the partnership's debts and liabilities, a KG consists of at least one general partner with unlimited personal liability and one or more limited partners which are only liable with their subscribed and registered partnership contribution. A partnership has a quasi-legal entity status, i.e. can enter into contractual relationships, own assets and incur liabilities in its own name and on its own behalf.

The major reasons for investors to use a partnership instead of a corporate structure are:

- The greater flexibility in tailoring the internal affairs to the individual needs of the partners;
- Fewer publication requirements (the partnership agreement need not be filed with the Commercial Register);
- Easier way to dissolve a partnership and distribute its capital to the partners
- Direct management by the (general) partners;
- An advantageous gift and inheritance tax treatment, useful for a family owned business facing a generation shift within the family.

Against this background, partnership structures are commonly used for smaller and family owned businesses.

Formation and Registration

To set up a partnership, at least two partners are required. Possible partners (general as well as limited partners) of a German partnership can be individuals, German or foreign corporations or other partnerships.

The formation of a partnership requires the execution of a partnership agreement. While it is possible to have an oral partnership agreement (as opposed to a corporation, notarization is not required), it is more common and preferable for it to be in writing. The partnership must then be registered with the relevant Commercial Register. To achieve the liability protection for the limited partners, the amount of the subscribed partnership contribution must be properly registered with the Commercial Register to become legally effective. If the KG commences its business activities prior to its registration, all partners including the limited partners are, in principle, fully liable for any obligations arising from such preregistration dealings. The liability of the limited partners will only become limited upon the registration of the KG and the subscribed partnership contribution with the Commercial Register.

Transfer of Partnership Interest

The transfer of any partnership interest (as limited or general partner) requires an agreement (written or oral) between the transferor and the transferee together with the consent of all other partners unless the partnership agreement provides otherwise. The partnership agreement may also impose certain restrictions relating to the transfer of a partnership interest. The change of partners must be registered with the Commercial Register.

Management

The partners may, in principle, freely agree upon their rights and obligations in the partnership agreement. However, limited partners are excluded by law from managing the partnership; it is only possible to grant limited power of attorney to limited partners (i.e. for certain types of transactions). The management responsibility is undertaken by all general partners of a partnership (oHG and KG). It is possible to restrict some general partners from managing the partnership. If the general partner is a corporation, the management of such corporation manages and legally represents the partnership.

The limited partners have certain information rights. In particular, they are entitled to request a written copy of the financial statements of the KG, as well as to inspect the records and accounts of the KG, in order to verify that the financial statements are correct. The partners determine the affairs of the partnership through partnership resolutions. Partnership resolutions must generally be passed unanimously. Although the partnership agreement may modify this principle, certain decisions relating to the fundamentals of the partnership exist which by law require the unanimous resolution of all partners. Majority decisions are therefore not always possible, as with a GmbH or AG. The position of partners who acquire only a minority interest in a partnership is, therefore, slightly stronger than it would be in a GmbH or AG.

GmbH & Co. KG

One very popular way of achieving the advantages of a partnership structure (e.g. because of its advantageous tax treatment in some regards), but nonetheless shielding the partners from an unlimited personal liability risk as in a corporation, is to appoint a corporation (generally a GmbH) as the sole general partner of the KG, thereby forming a so-called GmbH & Co KG. Usually, the limited partner(s) also holds all shares in the GmbH which acts as the general partner. The result of this structure is that the limited partner(s) are not only holding all interest in the KG directly and indirectly via the GmbH but are also controlling the partnership via their shareholding of the GmbH, even though they are excluded from managing the KG directly.

Ongoing Accounting Obligations and Disclosure Requirements

A KG must keep accounting records and prepare annual financial statements in accordance with the provisions of the German Commercial Code (HGB) which lay down detailed requirements as to the form and content of the annual financial statements. Unless at least one general partner is a natural person, a medium-sized or large KG must have its annual financial statements audited. Subject to the same exception (one general partner being a natural person), the (audited) annual financial statements must be filed with the Commercial Register within twelve month of the end of each financial year. Furthermore, any actual changes relating to the registered information (e.g. registered office, registered partnership contribution etc) must be notified to the Commercial Register.

Thomas Weidlich, LL.M.
thomas.weidlich@luther-lawfirm.com

Dr. Angelika Yates
angelika.yates@luther-lawfirm.com

	Aktiengesellschaft (AG)	**Gesellschaft mit beschränkter Haftung** (GmbH)
Incorporation and Registration Costs	Approx. € 1,000 to € 1,500	Approx. € 600 to € 1,000
Duration of Incorporation and Registration	2 to 8 weeks	2 to 6 weeks
Minimum Number of Shareholders	One	One
Formal Requirements of Incorporation	Notarised deed of incorporation and registration with commercial register.	Notarised deed of incorporation and registration with commercial register.
Minimum Share Capital	€ 50,000	€ 25,000
Capital Contribution (Cash)	25 per cent of the registered share capital (minimum € 12,500) plus full amount of any premium.	25 per cent of the registered share capital (minimum € 12,500).
Maintenance of Capital	Strict rules. In particular, no distribution of company's assets to shareholders (except for dividend payments out of distributable profits). Prohibition on financial assistance for acquisition of its own shares and principles on equity replacing shareholder loans apply.	No payments to shareholders which would reduce the company's net assets below its registered share capital. Principles on equity replacing shareholder loans apply.
Management	Management board and compulsory supervisory board with participation of employees: if more than 500 employees 1/3; if more than 2,000 employees 1/2 of the members of the supervisory board must be employees' representatives.	Minimum of 1 managing director. Supervisory board only required if more than 500 employees. Participation of employees: if more than 500 employees 1/3; if more than 2,000 employees – of the members of the supervisory board must be employees' representatives.
Directors' Liability	The directors are liable in relation to the company in case of a breach of their managing duties.	The directors are liable in relation to the company in case of a breach of their managing duties.
Shareholders' Liability	Limited to capital contribution.	Limited to capital contribution; with the exception of actions of the shareholders justifying the application of the "piercing the corporate veil" doctrine.
Transfer of Shares	Execution of a transfer agreement. No notarization required.	Notarized transfer deed required.
Costs of Share Transfer	No notary fees incur.	Fees of the notary public are generally based on the purchase price.
Expatriation	Results in the dissolution of the company.	Results in the dissolution of the company.
Accounting	National and international accounting standards.	National and international accounting standards.
Taxation	Taxable in Germany (corporation tax and trade tax).	Taxable in Germany (corporation tax and trade tax).

	GmbH & Co. KG	**Societas Europaea** (SE)
Incorporation and Registration Costs	Approx. € 1,000 to € 1,500	Depends on type of incorporation.
Duration of Incorporation and Registration	2 to 8 weeks	(See above)
Minimum Number of Shareholders	Two	One
Formal Requirements of Incorporation	Execution of partnership agreement and registration with commercial register.	Notarised deed of incorporation and registration with commercial register.
Minimum Share Capital	No minimum partnership contribution required.	€ 120,000
Capital Contribution (Cash)	No minimum payment requirements for the KG.	25 per cent of the registered share capital (minimum € 12,500) plus full amount of any premium.
Maintenance of Capital	None. (However the limited partners become unlimited liable for the liabilities of the partnership in case their contribution is paid back).	Strict rules. In particular, no distribution of company's assets to shareholders (except for dividend payments out of distributable profits). Prohibition on financial assistance of acquisition of its own shares and principles on equity replacing shareholder loans apply.
Management	GmbH as general partner manages the partnership.	Depending on outcome of negotiation procedure.
Directors' Liability	The general partner is liable in relation to the company in case of the breach of his managing duties.	See AG
Shareholders' Liability	Unlimited liability of the general partner; liability of the limited partners is limited to their contribution.	See AG
Transfer of Shares	Transfer of the interest in the KG requires the consent of all partners. Notarization required if both the KG-interest and the shares in the GmbH are transferred.	See AG
Costs of Share Transfer	Transfer of partnership interest does not incur notary fees.	See AG
Expatriation	Does not result in the dissolution of the company.	Relocation of the business and the registered office is possible.
Accounting	National accounting standards.	See AG
Taxation	Partnership is only subject to trade tax. The partners are taxed on the distributed profits.	See AG

Chapter 2

Taxation in Germany

by Dr. Eberhard Kalbfleisch

The German tax system is rather complex and has undergone several major reforms in the last years. Additional tax reforms have already been enacted in 2006 under the new German government, or are currently in the legislation process. The following information on German taxes relates to applicable law as of June 2006.

With effect as of the tax year 2001, the formerly applicable imputation/corporate tax credit system (Anrechnungsverfahren) was replaced by the so-called half-income system (Halbeinkünfteverfahren) in respect of dividends received from corporations and capital gains derived from the sale of shares in corporations. The transition from the imputation system to the half-income system is subject to lengthy and complicated transition rules that will generally continue to apply until the tax year 2019 to corporations with retained profits created under the imputation system.

Another major German tax reform introduced significant changes with effect as of the tax year 2004 such as a restriction concerning the utilization of loss carry forwards, the tightening of the thin capitalization rules and the taxation of 5 per cent of capital gains realized from the sale of shares, and of German dividends received by a corporate shareholder.

A tax reform is currently proposed in connection with the introduction of the European Corporation, concerning in particular the uniform treatment of German and European cross-border mergers and other reorganizations.

Milestones for a comprehensive reform of enterprise taxes with effect from the tax year 2008 have been agreed between the coalition parties, proposing a decrease of the current standard total tax rate of German corporations from 38% to below 30%. To finance such decrease in tax rate, various possibilities are being discussed to increase the tax base, such as a restriction of interest deduction, an increase of the taxable portion of dividends or an increase of the minimum taxation. This proposal is still in a very early stage and no reliable statement can be made as to whether and in what form it will in fact become law.

Corporations

General

German corporations (i.e., AG, GmbH and KGaA) and foreign corporations that are tax residents in Germany are subject to German corporate income tax (Körperschaftssteuer, CIT), plus a solidarity surcharge on their worldwide income (unlimited tax liability). A corporation is a tax resident in Germany if it has its legal seat in Germany or if it is effectively managed and controlled in Germany. The place of effective management and control is defined as the place where the board of directors (or equivalent) meets to determine strategic policy issues.

Corporations not tax resident in Germany are subject to CIT plus solidarity surcharge with their German source income (limited tax liability). Corporations are also subject to Trade Tax on Income (Gewerbesteuer, TTI – cf. below).

Tax Rates

Under the half-income system, CIT is generally levied at a rate of 25 per cent. For the tax year 2003 the CIT rate was increased to 26.5 per cent to finance the damages resulting from the flood catastrophe incurred in the eastern part of Germany in summer 2002. Additionally, a solidarity surcharge introduced after the German reunification to meet the financial needs of the East German states is levied at a rate of 5.5 per cent of the actual CIT burden. Neither CIT nor the solidarity surcharge is tax deductible.

Partnerships

Both general and limited partnerships (OHG and KG) are treated as transparent for German CIT and IIT purposes. Income derived by a partnership is allocated to its partners, and each partner is subject to CIT or IIT (plus solidarity surcharge) on the partner's proportion of income at the partner's individual tax rate, regardless of whether the income is retained in the partnership or withdrawn by the partners. Withdrawals of income by the partners are therefore tax neutral. Whether the partners are subject to CIT or IIT on their proportion of income will depend on whether the partner is a corporation or an individual. The German tax system does not provide for a "check the box" option for partnerships to be taxed as a corporation. Partnerships engaged in commercial activities are also subject to TTI (cf. below).

Permanent Establishments (Branches)

General

Non-resident corporations or individuals who derive income from a permanent establishment located in Germany are subject to limited CIT or IIT liability with such income. Under most of the German tax treaties with other countries a permanent establishment is defined as a fixed place of business from which business activities, in excess of mere auxiliary activities such as storage of goods or procuring of information, are carried out. A permanent establishment is also created by a dependent agent or a representative of a dependent status who has the authority to conclude contracts in the name and on behalf of the foreign principal.

Tax Rates

Income derived from a German permanent establishment by a foreign corporation is subject to CIT at a rate of 25 per cent plus solidarity surcharge. Progressive IIT rates (plus solidarity surcharge) apply to foreign individuals. Furthermore, the income is subject to TTI.

Individuals

Please refer to the Chapter "Visiting, Living and Working in Germany" for further information on individual income tax (IIT).

Trade Tax on Income

General

Any income derived from business activities carried out in Germany is subject to TTI irrespective of the form in which the business is carried out (e.g. sole proprietorship, partnership or corporation). TTI is a municipal tax, the assessment rate of which is set by the municipalities. TTI qualifies as a deductible expense for CIT purposes and is also deductible from its own basis. Partnerships are not treated as transparent for TTI purposes and are therefore themselves subject to TTI on their trade income.

Tax Rates

Because the assessment rate for TTI is determined by the municipalities, tax rates vary from municipality to municipality and therefore depend on where the business is located. Effective TTI rates (taking into consideration the deductibility of TTI from its own basis) generally range from 15 per cent to 20 per cent. As of the tax year 2004 a minimum TTI rate of 9 per cent was introduced to close down municipal TTI havens.

Individuals conducting a business as sole traders or through a partnership are granted a partial tax credit for TTI on their personal income tax liability to compensate for the higher income tax rates paid by an individual on business income compared with the CIT rate.

Losses

CIT and IIT losses may be offset against income in the same year or may be carried back to the previous tax year up to an amount of € 511,500. CIT and IIT losses can be carried forward without limitation as to time or amount; however, restrictions on the utilization of the loss carry forwards in any given year were introduced with effect as of the tax year 2004. Loss carry forwards may fully offset income in an amount of up to € 1 million. For income in excess of this amount, the utilisation of loss carry forwards is limited to 60 per cent, i.e., the remaining 40 per cent of the income in excess of € 1 million is subject to tax, even if additional loss carry forwards are available.

TTI losses may not be carried back, but may be carried forward under the same conditions as CIT and IIT losses. Further restrictions on the use of losses apply under certain conditions if more than 50 per cent of the shares in a loss-making corporation are transferred or if the corporation is merged.

Taxable Income

CIT Purposes

The basis for determining the taxable income for CIT purposes is the income shown in the commercial profit and loss statement to which certain adjustments will be made. The principal differences result from non-deductible items such as CIT and solidarity surcharge, hidden dividend distributions, 30 per cent of entertainment expenses and 50 per cent of the compensation paid to members of a supervisory board, and from the different tax treatment of self-created intangible assets, provisions for contingent losses, liabilities and provisions for long-term obligations exceeding one year, pension and anniversary provisions, provisions for maintenance and write-downs in value.

Except for capital gains derived from the sale of shares in corporations, the German CIT system does not distinguish between regular trade income and income derived from the sale of assets. German source capital gains are calculated as the difference between the current book value of an asset and the proceeds received, and are in principle subject to CIT at the regular rate. The taxation of capital gains from the sale of certain fixed assets (i.e., land and buildings) can be deferred under certain conditions by deducting them from the acquisition cost or cost of production of new replacement assets (roll-over relief) or by setting-up a tax-free reserve.

Capital gains derived from the sale of shares in a German or foreign corporation are generally tax exempt, irrespective of the amount of shareholding or the period for which the shares were held prior to the sale. However, corresponding to the treatment of dividends, 5 per cent of the tax-exempt capital gain will be treated as non-deductible expense and will thus in effect be subject to tax.

The tax exemption does not apply to the extent that tax effective write-downs in value on the shares have been claimed in earlier years and have not been recaptured in the meantime. The exemption does also not apply if the shares in the corporation have been issued in exchange for the contribution of business assets at a value below fair market value under the German Transformation Tax Act within a period of seven years prior to the sale of the shares. Losses incurred in connection with the sale of shares in corporations are non-deductible. Write-downs in value on the shares are not accepted for tax purposes.

Dividends received from a German or foreign corporation are generally exempt from CIT. However, corresponding to the treatment of capital gains, 5 per cent of the tax-exempt dividend will be treated as non-deductible expense and will thus in effect be subject to CIT. Actual expenses incurred in connection with the shareholding in a corporation are fully tax deductible.

Income derived from permanent establishments located in treaty countries is exempt from CIT under most German tax treaties. Tax credits are available for income derived from permanent establishments in non-treaty countries.

IIT Purposes

Please refer to the Chapter “Visiting, Living and Working in Germany” for further information.

TTI Purposes

The assessment basis for TTI is calculated by making various adjustments to the income subject to CIT. The most important examples thereof are the increase of the CIT basis by adding back 50 per cent of interest on so-called long-term debts (i.e., debts incurred in connection with the formation or extension of the business or for a period in excess of one year), by adding back the dividends from German or foreign corporations for which certain holding and activity requirements are not fulfilled, and the decrease of the CIT basis by deducting the profit shares from German or foreign partnerships.

Withholding Taxes

Dividends

Dividends distributed by a German corporation are subject to withholding tax (WHT) at a rate of 20 per cent (plus 5.5 per cent solidarity surcharge). Where distributions are made to EU corporate shareholders the WHT is, upon application, reduced to zero if the EU entity directly has held at least 25 per cent (or, depending on the applicable double tax treaty, 10 per cent) of the share capital of the German corporation for an uninterrupted period of at least 12 months at the time of the dividend distribution. For distributions to foreign non-EU shareholders, the double tax treaties with the respective countries provide for WHT reductions to 5 per cent, 10 per cent or 15 per cent if certain holding requirements are fulfilled.

Interest

WHT of 25 per cent (plus 5.5 per cent solidarity surcharge) is levied on interest from profit participating loans and from silent participations. Interest payments made on fixed interest bearing loans, on bonds and on other interest bearing securities are subject to WHT at 30 per cent (plus 5.5 per cent solidarity surcharge) if made by banks or financial institutions, with some exceptions. Interest payments made by a German corporation on a fixed interest-bearing loan from its German or foreign shareholder are not generally subject to WHT.

Royalties

Royalties, e.g. for the use of patents, know-how and other intellectual property rights, are only subject to WHT if paid to a non-resident. The WHT rate amounts to 20 per cent (plus 5.5 per cent solidarity surcharge), however, reductions of, or exemptions from, WHT are available under most German double tax treaties.

Wage Tax

Employers are responsible for withholding wage tax (plus solidarity surcharge) from wages and salaries paid to employees.

Tax Consolidation

Tax consolidation is available for CIT and TTI purposes under the "Organschaft" (tax group) concept. Organschaft exists where one or more German corporations are financially integrated into the business of a German parent corporation or partnership or a German branch of a foreign enterprise and have concluded a profit and loss absorption agreement with the parent so that the profits and losses generated by the integrated companies will be allocated to and aggregated with the profits or losses of the parent for tax purposes. The formerly applicable additional requirements of economic and organizational integration were abolished for CIT purposes with effect from the tax year 2001 and for TTI purposes with effect from the tax year 2002.

Administration

Filing of Tax Returns

The tax year in Germany is the calendar year. While companies may have business years deviating from the calendar year, the change of the business year from the calendar year to a different period requires the prior approval of the Tax Authorities. CIT and TTI returns must be filed annually. The general filing deadline is five months after the end of the tax year under assessment, i.e., May 31, 2007 for business years ending in the year 2006. An automatic extension of four months is granted for tax returns prepared by a tax advisor. Further extensions may be granted upon application.

Payment of Taxes

Quarterly CIT and TTI prepayments have to be made which will be assessed by the tax authorities based on the taxable income of the prior year or, for newly established businesses, based on a forecast of the taxpayer.

Tax Field Audits

All substantial business operations are subject to full scale, on-site tax field audits on a more or less continuous basis. Annual taxes will normally be assessed subject to review, based on the tax returns filed by the taxpayer, and final assessments will only be issued after a tax field audit has been carried out. Since January 1, 2002, the tax authorities may, in the course of a tax field audit, request access to the EDP system of the taxpayer; i.e., to not only ask for print-outs of EDP documents, but also to use their own review tools on the EDP system.

Anti-Avoidance Rules

General

The German tax system operates under the principle of "substance over form" and places particular emphasis on the economic background and intention of transactions and structures. The General Tax Code contains provisions according to which tax laws may not be avoided by the abuse of legal structures with agreements, even if legally invalid, being taken into account for tax purposes to the extent the parties in fact observe the economic effects of such agreements. The Income Tax Act (Einkommensteuergesetz, EStG) furthermore contains an express provision against treaty shopping.

CFC Legislation

Germany has extensive CFC legislation under which income created by passive foreign subsidiaries in low tax countries can be attributed to the German shareholder and subjected to German tax.

Transfer Pricing

Inter-company pricing between affiliated companies must be on an arm's length basis to be accepted for tax purposes. The German Ministry of Finance (Bundesfinanzministerium) has issued a "Decree Concerning the Principles Applying to the Income Allocation Between Internationally Affiliated Enterprises" which defines in detail how arm's length prices are to be determined. Inter-company pricing is especially vigorously pursued by the German tax authorities where multinational groups are involved. Charges for goods and services to a German enterprise by a foreign affiliate (and vice versa) that are not on an arm's length basis will be adjusted accordingly and increase the basis for German CIT and TTI.

In addition there are documentation requirements for transfer prices with affiliated companies, ie.e, the taxpayer is obliged to record the types and contents of its cross-border transactions with related parties, and to provide information on the economic and legal background of inter-company transactions to the extent relevant for the determination of arm's length transfer prices. If such documentation cannot be provided the tax authorities can make income adjustment based on estimates, and penalties can be imposed.

Thin Capitalization Rules

The German thin capitalization rules provided for in Sec. 8a of the Corporate Income Tax Act (Körperschaftssteuergesetz, KStG) formerly only applied to loans granted to a German corporation by foreign shareholders directly or indirectly holding more than 25 per cent of the share capital of the German corporation, or by foreign related parties. Following the so-called Lankhorst-Hohorst decision dated December 12, 2002 in which the European Court of Justice ruled that the provision violated EU law, the thin capitalization rules were significantly changed with effect for the tax year 2004.

The thin capitalization rules were extended to apply to all loans granted to a corporation subject to unlimited or limited German tax liability by a German or foreign shareholders owning directly or indirectly at least 25 per cent of the share capital of the borrowing corporation, by persons related to such shareholders or by third parties who can take recourse to a shareholder or to a person related to a shareholder.

The thin capitalization rules apply accordingly if a loan is granted to a partnership in which a corporation holds an interest of at least 25 per cent. In this case, for tax purposes the loan is deemed to be granted to the corporation. The thin capitalization rules do not apply if the annual interest payments do not exceed a threshold of € 250,000.

Guidelines on the application of the new thin capitalization rules was published by the German Ministry of Finance on July 15, 2004 and on July 22, 2005 (the "Guidelines"). According to Sec. 8a KStG, interest payments made by a corporation to its shareholder directly or indirectly holding more than 25 per cent of the share capital, or a party related to such shareholder, will be recharacterized as hidden dividend distributions and added back to the corporation's taxable income, both for CIT and TTI purposes, if and to the extent that the loan granted by the shareholder/related party exceeds certain debt to equity ratios (safe haven), unless the corporation can prove that it would have received the loan at the same terms and conditions from an unrelated third party (such as from a bank). Hidden dividend distributions are subject to WHT as described above for regular dividends.

No safe haven is available for other than fixed interest bearing loans (e.g., profit participating loans), i.e., interest payments on loans from shareholders/related parties, where the remuneration is calculated other than as a fixed percentage of the loan generally qualify as hidden dividend distributions.

German thin capitalization rules generally also apply to loans granted by third parties who can take recourse to the shareholder or a person related to the shareholder. However, according to the Guidelines, this is not the case if the borrowing company can prove that the collateralization of such loan does not qualify as back-to-back financing. The requirements of back-to-back financing in these terms are fulfilled if the lender has a legally enforceable claim for recourse on a not only short term interest bearing deposit or other receivable of the shareholder or a person related to the shareholder. The application of the thin capitalization rules on third party loans can thus be avoided by excluding any interest bearing long term deposits and receivables from the security package. The absence of back-to-back financing has to be evidenced by the borrowing corporation. The evidence can be furnished by a certificate of the financing third party, confirming that it has received no other securities than those listed in the certificate.

For fixed interest bearing loans, the debt to equity ratio is 1.5 to 1, both for operating companies and for qualified holding companies. The former more beneficial debt to equity ratio of 3 to 1 for holding companies was reduced with effect from the tax year 2004.
The equity relevant for the calculation of the safe haven is the proportionate capital of the shareholder (paid in share capital plus capital reserves plus profits carried forward plus current profits minus losses carried forward minus current losses plus 50 per cent of special reserves with an equity portion) as shown in the commercial balance sheet of the corporation at the end of the previous financial year. The capitalized value of investments in other corporations has to be deducted if the investing corporation does not qualify as a holding company in terms of the thin capitalization provisions. A holding company is a company whose principal activity consists of holding and financing shares in at least two (not necessarily German) corporations.

Apart from the changes introduced to comply with EU law, the tax reform also introduced a new thin capitalization scenario in Sec. 8a para 6 KStG to deny tax benefits resulting from the financing of internal reorganizations. If a loan is granted for the purpose of financing the acquisition of shares in a corporation and both the seller and the lender are shareholders, related parties or secured third parties, the interest deduction is denied altogether, regardless of the debt to equity ratio. The threshold of € 250,000 is not applicable in this scenario. In the absence of grandfather provisions, the new scenario also applies to loans granted for group reorganizations completed prior to the introduction of the new rule.

This new scenario is not commented on in the Guidelines. The German Ministry of Finance is currently working on a separate guideline on the application of Sec. 8a KStG, a draft of which was circulated in December 2005. According to the draft in its current form, it is intended to exclude secured third party loans from the regulation, if it can be evidenced that they do not qualify as back-to-back financing. It is, however, currently not clear whether this view will be maintained in the final version and when the guideline will officially be published.

Other Taxes

Value Added Tax

Value Added Tax (VAT) is currently levied on the supply of goods and services in Germany at a rate of 16%. A reduced rate of 7% applies to a number of goods and services such as the delivery of books and certain food items and taxi services within city limits. The general VAT rate will be increased from 16% to 19% with effect from January 1, 2007. The reduced VAT rate of 7% will remain unchanged.

Any entrepreneur supplying goods or services in Germany is liable for VAT, regardless of legal form and nationality. The German VAT system is designed so that the VAT is ultimately borne by the end-customer. VAT charged to an entrepreneur for goods supplied or services rendered by another entrepreneur may, therefore, be claimed as input VAT, with some restrictions.

The entrepreneur has to file quarterly or, if VAT due in the previous year exceeded 6,136, monthly preliminary VAT returns, as well as annual VAT returns.

Real Estate Transfer Tax

Real Estate Transfer Tax (Grunderwerbssteuer, RETT) is levied on the sale and transfer of real estate located in Germany and on certain other transactions deemed to be a transfer of real estate, such as the transfer of at least 95 per cent of the shares in a company owning real estate or the complete or almost complete change of the partners in a partnership owning real estate. A complete or almost complete change of partners occurs if, within a period of 5 years, at least 95 per cent of the partnership interest is transferred to one or several new partners. The tax rate amounts to 3.5 per cent. The basis for RETT is the consideration paid for the real estate or, in certain situations, a special assessed tax value of the real estate.

Inheritance and Gift Tax

Inheritance and Gift Tax is levied on the transfer of property by gift or by inheritance. Where neither the donor/decedent nor the beneficiary is a German resident, taxation is limited to property located in Germany. The tax rates vary from 7 per cent to 50 per cent, depending on the degree of family relation and on the value of the property inherited or gifted. Tax allowances are available for spouses and children, and for the transfer of business assets and shares in domestic corporations.

Dr. Eberhard Kalbfleisch
eberhard.kalbfleisch@luther-lawfirm.com

Chapter 3

Mergers and Acquisitions

by Thomas Köhler; Dagmar Witzorrek

The catch-all term "Mergers and Acquisitions" (M&A) covers all kinds of corporate consolidations including the acquisition of a business or a company in whole or in part, management buy-outs, management buy-ins, joint ventures and all transactions relating to such acquisitions, such as pre-sales and post-completion restructurings. In the light of the recent decision of the European Court of Justice (Europäischer Gerichtshof, EuGH) of December 13, 2005 ("SEVIC") and the European Merger Directive issued on December 15, 2005, the term also covers cross-border mergers that are implemented on the basis of the German Law regulating the Transformation of Companies (Umwandlungsgesetz, UmwG) and a corresponding foreign law.

In the following, the typical procedure and features of M&A transactions, particularly with respect to cross-border transactions, will be outlined.

The Typical Procedure in M&A Transactions

Although every M&A transaction is unique, there is a typical pattern to all such deals. However, if the target business is sold by controlled auction, such as the case of a privatization, the procedure may slightly differ.

Pre-Sale Reorganization

Ideally, the seller can sell its business "as is" and the potential purchaser is interested in exactly that business. But as a rule the seller wants a pre-sale reorganization in order to construct the business to be sold at its discretion (e.g. by transferring assets which are to be retained to another group company or by transferring assets to be sold to a newly incorporated subsidiary in preparation for selling the shares in this company). On the other hand, the potential purchaser might also request a specific business structure, often in order to make a tax-optimized acquisition.

First Talks / Letter of Intent

The first contact between the seller and the purchaser is frequently organized by an M&A advisor, such as an investment bank. In this first phase, the M&A advisor normally prepares an information memorandum to inform the potential purchaser about key data of the target business (size, locations, number of employees, sales markets, etc.).

If the parties decide to pursue the transaction further, they usually agree on a letter of intent (LoI) or memorandum of understanding (MoU). Primarily, this LoI / MoU confirms the intent of the parties to carry out the contemplated transaction, states the outcome of previous negotiations and defines the further course of the transaction procedure. As the purchaser incurs considerable costs and expenses during the subsequent phases, in particular in connection with the due diligence review of the target business, it is in the purchaser's interests to agree on an exclusivity period during which the seller is not allowed to otherwise sell or negotiate the sale of the target business.

Although the LoI / MoU could be legally binding, the parties normally agree that it shall be a non-binding document. However, experience shows that even if the LoI / MoU is intended to be non-binding, it is very difficult to depart from the terms set forth in the LoI / MoU in subsequent negotiations.

Due Diligence

The LoI / MuO is usually followed by a due diligence review. A due diligence review is a review of the target's legal, economic, financial, tax, personnel and other affairs, such as environmental, cultural, technological, that is carried out by the purchaser and its advisors. The potential purchaser normally sends a list of questions in advance, which are answered during the due diligence process. The results of the due diligence review are summarized in a due diligence report.

The purpose of a due diligence exercise is not only to enable the purchaser to examine the target business to decide whether or not it meets its expectations, but also to obtain a sound basis for subsequent negotiations, in particular with respect to the determination of the purchase price as well as representations and warranties. Thus, the due diligence is an essential precursor to contractual protection and helps to identify the level and areas of protection needed.

The seller of interests in a German partnership or shares in a GmbH generally has extensive information about the target business that it can provide to the purchaser. Even if the seller does not have such information, the management of the target company may allow a purchaser to pursue a due diligence if the other shareholders have approved such a review. The seller of shares in a German AG, on the other hand, usually does not have extensive information about the company's business, and the management board may only provide such information to a potential purchaser if the contemplated transaction is in the best interests of the company and the purchaser has signed a confidentiality agreement. Moreover, if the target AG is listed, information restrictions may also be stipulated by provisions relating to the capital market.

Negotiation Phase

If the due diligence has not revealed any deal breakers, it is followed by the negotiation of the specific terms and conditions of the transaction and the preparation of the contractual documents. Unless the bargaining position of the seller is much stronger than that of the purchaser (as is generally the case in controlled auctions), the drafting is normally done by the purchaser.

Signing and Closing

The Anglo-Saxon concept pursuant to which the signing of the sale and purchase agreement and the closing or consummation of the transactions traditionally take place at two different points in time is being adopted in Germany to an increasing extent, in particular in connection with large, complex transactions that require several rounds of approval, including board approval or merger clearance (for details regarding merger clearance, please see the chapter on anti-trust law). In these cases, the sale and purchase agreement is signed when the parties have agreed on all terms and conditions, while closing occurs at a later point in time, usually after all approvals or other conditions precedent have been obtained or fulfilled.

Post-Closing Integration / Post-Closing Restructuring

The success of an acquisition is especially dependent on the successful integration of the acquired business into the existing operations of the purchaser. Such integration is normally less complex in a share deal than in an asset deal, since in the latter case every individual asset and liability sold must be transferred and integrated. Moreover, in an asset deal there will be other post-completion matters to attend to, such as administrative matters such as insurance, payroll, VAT and pensions.

With respect to representations and warranties, each purchaser is advised to set up a process to monitor any potential warranty claims that arise so that the deadlines are not missed. If the seller grants certain guarantees as to the amount of equity of the target company as of the closing date (in a share deal) or the amounts of accounts receivable (in an asset deal), a closing balance sheet or other financial statements must be prepared after the acquisition. Sometimes, the purchaser also decides on post-sales restructuring. This is often performed for tax purposes.

Special Features of a Cross-Border M&A Transaction

Choice of Law

In cross-border transactions, it is essential for the parties to choose the law that will govern the contracts. There may be disagreement because both the seller and the purchaser wish the governing law to be the law of their home country, particularly if the parties come from different legal systems (e.g., civil-law system versus the common-law system). In this context, however, the parties have to keep in mind that under German law the legal transfer of assets/participations comprises two separate legal acts: an agreement under the law of obligations (= sale and purchase agreement) in which the parties agree on the commitment to transfer the relevant assets/participations, and a further agreement in rem (= transfer agreement) for the change in ownership of the assets/participations sold. However, both agreements are normally incorporated into one document.

According to German international law the parties are only free to decide on the law governing the sale and purchase agreement, and have no choice regarding the law applicable to the transfer since the transfer of assets/participations is mandatorily governed by the law of the country in which the assets are located or – with respect to participations being sold – in which the company is based.

Sources of Law

In Germany, there are no laws relating specifically to the acquisition of businesses by asset deal. The existing legal provisions on the sale of individual rights and assets do not cover the specifics of the sale of a business as a collectivity of rights and assets. Therefore, the parties ordinarily agree on their own set of rules.

Although international standards for M&A contracts that have evolved in the Anglo-Saxon world in particular are increasingly being adopted in Germany, a contract governed by German law is still much “shorter” than a contract subject to common law. Since German law has codified many general and abstract rules which take effect unless otherwise stipulated by the parties, there is no need to describe and define every single detail, as is the case in common law contracts, but it is sufficient to make reference to codified legal definitions and codified legal consequences.

Choice of Language for the Negotiations and Documents

Besides the choice of law, the choice of language is an important issue – even from a psychological perspective. Clearly, if the parties do not ordinarily communicate in the same language, each party will try to ensure that the negotiations are conducted and contracts drafted in their own language. The choice of law and the choice of language are usually interconnected: if the parties wish to regulate their legal relationship in one particular language, there is likely to be some logic to adopting the law of the jurisdiction where that language is spoken, and vice versa. So, even though English has become the common language in international transactions, a German seller does not have to agree on using the English language. Under certain circumstances it could be advantageous for the foreign investor to waive the usage of the English language for the negotiations and the documents and to accept the German language instead, as this could be seen as a positive signal to the German contractual partner that the foreign investor is not interested in an unfriendly takeover of the German business but is willing to cooperate (particularly if the target is a family-owned business).

Interdisciplinary Questions during M&A Transactions

There is typically a whole array of economic, legal, technical and social issues to address during M&A transactions. Thus, it is advisable for each party to select an interdisciplinary team of advisors for all phases of the transaction in order to ensure that all relevant issues will be considered. From the seller’s point of view, the involvement of an interdisciplinary team is already important during the planning phase if the seller is looking to restructure the business up for sale and to address all relevant issues and disclose potential risks relating to the business sold in order to be prepared for the negotiation phase.

Deal Structure of Asset Deals

While the decision on the sale or acquisition of a business is frequently driven by many different objectives (external growth, changes in the field of business, financial issues, etc.), the actual deal structure is often shaped by the financing of the transaction and tax issues.
When a business is sold in an asset deal (in whole or in part), the purchaser acquires individual assets that in aggregate make up the business sold. This kind of deal structure is often used if the purchaser is not interested in acquiring the whole business or if certain risks have been identified which the purchaser does not want to take on. To a certain extent, an asset deal enables the purchaser to do “cherry picking”.

The following aspects should be highlighted with respect to asset deals:

Sale and Transfer of Individual Assets

With respect to the sale and transfer of individual assets and liabilities, the parties especially have to consider the following:

- *Sale and transfer agreement:* As a number of individual assets and (possibly) liabilities are sold and transferred, the sale and transfer agreement must specifically describe and define the assets and liabilities being sold. A general description such as

"all fixed assets and inventory relating to the business" is not sufficient. However, this requirement can be met by attaching computer printouts of the assets and liabilities sold, which are often available from the electronic accounting system of the tar get business.

- *Transfer of accounts payable/contracts:* The transfer of accounts payable and contracts requires the consent of the respective creditors and contracting parties. This consent may be, and usually is, obtained after the execution of the sale and transfer agreement. In this case, the purchaser has to insist on specific provisions in the event that such consent is not granted (e.g., reduction of the purchase price, right of withdrawal, etc.).

- *Transfer of licences and permits:* As a rule, public licence and permits relating to the operation of the business (betriebsbezogene, sachliche Genehmigungen) may be transferred. On the other hand licences and permits relating to a specific person (personenbezogene Genehmigungen) cannot be transferred from the seller to the purchaser, as a rule; the purchaser has to apply for a new licence in order to continue the acquired business.

- *Further approval requirements:* Besides the above consent requirements, there might be – depending on the assets sold – further requirements of approval from third parties (e.g., in the case of a chattel mortgage or if the assets constitute almost the entire property of the seller).

- *Requirements as to the form of the contracts:* The sale and transfer agreement only needs a specific form if assets are sold whose sale and transfer mandatorily require execution in a specific form (e.g., the sale and transfer of real property require a notarial deed). Otherwise, for purposes of proof the written form is advisable.

Transfer of Employment

The employment relationships of all employees belonging to the business being sold are transferred automatically to the purchaser pursuant to sec. 613a of the German Civil Code (Bürgerliches Gesetzbuch, BGB). The purchaser assumes all rights and obligations resulting from the employment relationships existing at the time of transfer. However, as employees are free to choose their employer, they have the right to object to their employment relationships being transferred. To enable the employees to exercise this right, the seller or the purchaser must notify the employees of the transfer of the business prior to such transfer. The effect of an objection by an employee is that his or her employment relationship is not transferred to the purchaser and remains with the seller. Unless the latter has another position for the employee raising the objection, it may terminate the employment relationship for compelling business reasons. The purchaser is not entitled to terminate employment merely on the grounds of the business transfer. Termination of employment for other reasons, e.g., because of reorganization measures following the transfer of the business, is, however, still possible.

Employees' rights and obligations which are governed by the terms of a collective agreement or by a works agreement form the basis of the employment relationship between the purchaser and the employees and may not be modified to the detriment of the employees for one year from the date of transfer. This does not apply, however, if and to the extent that the purchaser has collective agreements or other works agreements covering the same subject matter, in which case these agreements replace those relating to the transferred business even if they are less favourable.

For further details please refer to the section Industrial Relations and Labour Legislation.

Liability of the Purchaser

In principle, the purchaser assumes only the liabilities expressly assigned to it pursuant to the sale and transfer agreement. An exception applies, however, with regard to the following liabilities governed by mandatory German law:

- *Tax law:* If the purchaser continues the business operations, it is jointly and severally liable for tax debts which have their sole basis and origin in the acquired business and which arose in the year preceding the transfer of the business. This concerns corporate income tax and VAT in particular.

- *Commercial law:* If the purchaser continues the acquired business under the former company name, then it assumes joint and several liabilities for all debts of the seller originating from the seller's business operations unless it is stated in the Commercial Register that such liabilities have not been transferred to the purchaser.

- *Employment law:* The purchaser is jointly and severally liable for obligations relating to transferred employees that fall due on or up to one year after transfer of the business.

Deal Structure of Share Deals

In a share deal, the purchaser acquires the shares in a company that owns a business. As a share deal does not affect the ownership of the company's assets, the purchaser acquires the company with all its assets, receivables, liabilities, obligations (even those it does not know about) and generally public licences and permits. The possibility for the purchaser to continue the business "as is" may be the decisive argument for carrying out a share deal.

The following aspects should be highlighted with respect to share deals:

- *Transfer of interests/shares:* Since the interests in German partnerships (OHG, KG, GmbH & Co. KG) are not freely transferable, such transfer always requires the approval of all other partners, unless the partnership agreement provides otherwise. In comparison, shares in a German corporation (GmbH, AG, KGaA) are freely transferable unless otherwise stipulated in the company's by-laws. The by-laws of family-owned GmbHs in particular often stipulate certain transfer restrictions (e.g., approval by the company or by the shareholders' meeting). The by-laws of an AG may only stipulate such restrictions with respect to the transfer of registered shares, while such consent requirements are not allowed for bearer shares.

- *Requirements as to the form of the contracts:* The sale and transfer of interests in a partnership and of shares in an AG do not need to be executed in a specific form; simple written form of the relevant contracts is sufficient. If an AG has issued share certificates, the shares may be transferred by endorsement (and delivery of the share certificate) or by simple transfer of the right, with title to the share certificate following by law. In contrast, contracts for the sale and transfer of shares in a GmbH must be drawn up in notarized form.

Joint Ventures

A joint venture is a commercial arrangement between at least two economically and legally independent partners. The establishment of a joint venture may be prompted by the scale of a project such as the joint financing of an expensive project or the need for special expertise (e.g., technical, marketing or cultural expertise). In particular, when a foreign investor intends to invest in a country with quite different cultural and/or political conditions, a joint venture is often used as the first move into the new market.

A joint venture can be established either by creating a new company or taking on shares in the joint venture company or by agreeing to collaborate on a contractual basis. In the first two cases, the parties become joint shareholders of the joint venture company. Thus, the company's by-laws (Gesellschaftsverträge, Satzungen) constitute the basis for the rights and duties of the parties as shareholders. However, since by-laws of corporations have to be published in the Commercial Register under German law, the shareholders generally also enter into a separate shareholders' agreement (Konsortialvertrag) in order to regulate those rights and duties that shall be kept confidential. Such shareholders' agreements often set out detailed rules on the management of the company and its business (e.g., appointment of the members of management and other corporate bodies, determination of management transactions requiring the prior approval of the shareholders), exercise of voting rights, financing, call options, put options, etc.

When the parties agree to collaborate on a contractual basis, the cooperation agreement commonly sets forth similar provisions to that of the shareholders' agreement, e.g., the scope and financing of the joint venture, the rights and duties of the participants, the sharing of returns and related costs, the duration of the legal relationship, etc.

Cross-Border Mergers

Based on the recent development regarding the permissibility of mergers between a German and a foreign company, cross-border transactions within the European Community that are executed on the basis of specific laws regulating the merger of companies will become more important in the future. Particularly from a German point of view, lengthy restructurings are no longer necessary in order to merge the business of a foreign investor into a German company, or vice versa.

The European Merger Directive must be implemented into law by the end of 2007 at the latest. In Germany it is intended to implement the respective Act at the beginning of 2007. However, a certain legal basis for cross-border mergers with the EUR will not be given until all EU-countries will have implemented the national acts on cross-border mergers. Until then, there will continue to be a lack of detailed definitions of the legal requirements for such cross-border mergers so that it is advisable to involve the respective German authorities at an early stage on the restructuring process to achieve the required registrations.

Thomas Köhler
thomas.koehler@luther-lawfirm.com

Dagmar Witzorrek
dagmar.witzorrek@luther-lawfirm.com

Chapter 4

Anti-Trust Law

by Dr. Helmut Janssen, LL.M.; Dr. Thomas Kapp, LL.M.

Two sets of anti-trust regulations are applicable in Germany. First, the GWB, which covers restrictions of competition that have an effect within Germany. Second, Article 81 to Article 86 of the Treaty of Rome ("EC Treaty") and the Regulations based on it (especially the Merger Regulation, see below). The European legislation is directly applicable in Germany; it catches anticompetitive practices that restrict trade within the European Union.

The purpose of the GWB is to protect freedom of competition. It aims to achieve this by prohibiting anti-competitive behavior and by safeguarding competitive market structures. EC anti-trust law has as its objective not only the freedom of competition, but also the integration of the internal European market. This leads sometimes to different results in practice depending on whether the EC Treaty or the GWB provisions are applicable and which authority or court applies them.

Unlike other jurisdictions, German law does not treat offences against anti-trust regulations as criminal acts. Another difference that can be of relevance to a foreigner seeking recourse to German anti-trust law: While a person suffering financial loss from an anticompetitive conduct can claim damages to compensate for this loss, he may not be awarded "treble damages", a remedy highly relevant e.g. in the USA.

German Anti-Trust Law

General

The GWB applies to all restraints of competition that have an effect within the area of the Federal Republic of Germany, even if such restraints have their origin outside Germany. The provisions of the GWB may therefore apply extraterritorially to the behavior of a company that is based or acts outside of Germany if such behavior significantly affects competition in the German market. The GWB has consequently been applied by the Federal Cartel Office (Bundeskartellamt, FCO) to agreements between foreign manufacturers on terms and conditions for exports to Germany or on agreements between foreign manufacturers regarding prices for goods exported to Germany.

Horizontal Restraints

Restrictions between parties that operate on the same level of the market are commonly referred to as horizontal restraints (e.g. two manufacturers of specific filters enter into a specialization agreement, a foreign investor forms a "strategic alliance" with a German competitor or concludes a "cooperation agreement"). All agreements between competitors, decisions by associations of competing companies and concerted practices aiming at or causing the prevention, restriction or distortion of competition are, in principle, prohibited. The prerequisite of "competing companies" is fulfilled if companies are factual or potential competitors in the relevant market. Companies are deemed „potential competitors" if, from a business point of view, they are in a position to penetrate the market of the other. The prohibited agreements or practices must furthermore have a significant effect on competition.

Since May 1, 2004, horizontal restraints which have an effect both on the German market and on trade between the EU member states may not be treated more strictly or more benignly by the GWB than by the EC Treaty. This is an effect of the supremacy of European Law as introduced by EC Regulation 1/2003. While this Regulation is applicable only to cases which have an effect on other member states German law was amended accordingly, in order to harmonize the rules for domestic cases to a high degree with the European scheme. This means that since July 1, 2005 (when the 7th Amendment to the GWB entered into force) both European and German law provide for statutory exemption of restrictive practices if they fulfill certain conditions: The restrictive agreement must contribute to the improvement of production or distribution of goods or promotion of technical or economic progress, while allowing consumers of fair share of the resulting benefit; furthermore, the restrictions must be indispensable and they must not eliminate competition.

Vertical Restraints

The supremacy of EC law over German law also applies to vertical restraints. While for merely domestic cases the GWB could provide for a different set of rules, the German parliament has decided that the European scheme shall apply to those domestic cases, too. This means that all vertical restraints are null and void unless they benefit from an exemption. The GWB now provides for the same statutory exemption as does EC law. In addition, the European block exemption regulation for vertical restraints has been integrated into German law. Therefore, all vertical restraints, except for minimum resale price maintenance, are exempted from the general prohibition if the market share of the enterprises involved is below 30 per cent. Under these circumstances, maximum

resale price maintenance, non-mandatory recommendations within a distribution system and most favored clauses are admissible. Vertical price fixing clauses are no longer prohibited per se.

Dominant Companies

Companies that have a dominant position in the relevant market may neither abuse this position nor discriminate or hinder other undertakings in an unfair manner. The abuse of a dominant position is prohibited. Market dominance is assessed by evaluating the supply and the demand side of a market: all products or services can be allocated to a certain relevant market if such products or services are, in the view of the other party, interchangeable in terms of feature, purpose of use and price, and are therefore suited to meet a certain demand.

A company dominates a market when it has no competitors, is not subject to substantial competition or enjoys a paramount market position. In order to determine whether or not a company has a paramount market position, all relevant factors must be taken into account: market share, financial strength, access to supplies or markets, links with other companies, ability to shift its supply or demand to other goods or commercial services, legal or factual barriers to market entry for potential competitors, actual or potential competition by other companies, the ability of the market participants to resort to other companies. An enterprise with a market share of one third is presumed dominant, but this presumption is rebuttable.

There are two basic forms of abuse. The first type deals in particular with the relationship between the dominant company and its competitors. An abuse exists if the dominant company – without having any objective justification – impairs the ability of other companies to act on the market in a competitive manner. This rule applies, for example, to some rebate systems. The second type of abuse is the so-called exploitation. Exploitation is deemed to exist if, for example, the dominant company requests a price or asks for business conditions different from those that would be likely if effective competition existed.

A dominant company is prohibited from, be it directly be it indirectly, hindering another company in an unfair manner in conducting business activities that are usually accessible to similar companies. Furthermore, the dominant company must not discriminate against another company (i.e. treat differently from similar companies) unless there is an objective justification for the different treatment. The determination of unfair hindrance, as well as unjustified discrimination, requires balancing the interests of the companies affected. When undertaking the balancing test, neither interests of third parties nor interests which lie outside the scope of the protection of competition (e.g. environmental issues) may be taken into account.

Companies with a Strong Market Position

A peculiarity of the German law is the application of the prohibition of discrimination and unfair hindrance to companies with a strong market position, rather than only to dominant companies. A strong market position will be assumed if small and medium-sized companies are depending on the strong company. Therefore, under German law the rules of discrimination and unfair hindrance may apply below the level of market dominance. This particularity of German law has persisted for unilateral behavior of a strong company, despite the general supremacy of the European law. This means that in a cross-border case such a behavior may be permitted by EC law but prohibited by German law. Typical examples for such a unilateral behavior are the refusal to deal and predatory pricing.

Merger Control

The acquisition of all or a substantial part of a company's assets or shares, a public takeover, the creation of a joint venture – these are typical transactions that qualify for merger control. As a rule, a transaction has to be notified to the FCO if, first, there is a combination between companies and, second, certain turnover thresholds are exceeded. If a notification is required the merger is suspended until clearance by the FCO. Any transaction consummated without obtaining this clearance is invalid and subject to a fine.

A planned transaction must be notified to the FCO if the annual worldwide turnover of all companies involved exceeds € 500 million and if the total turnover in Germany of at least one participating company exceeded € 25 million in the business year preceding the merger. For the purpose of calculating the relevant turnover, all affiliated companies controlled by or controlling one of the participating companies must be added, too.

The FCO is the sole German authority competent to investigate mergers. It has to prohibit mergers that might create or strengthen a dominant market position, unless the participating companies can demonstrate that the joining of their forces would in effect promote competition and that this promotion would outweigh the disadvantages of their dominant market position. As the GWB also applies to foreign transactions that might restrict competition within Germany, mergers of foreign companies may also fall within the scope of German merger control.

The FCO is obligated to decide within one month after receipt of the complete notification whether it will initiate an examination of the concentration. If the FCO decides, the second phase of the concentration review should be completed within four months after receipt of the complete notification. If the FCO does not decide within the given time limit of one month to initiate the second phase of its investigation the merger is deemed approved.

European Anti-Trust Law

European Anti-Trust Law (especially Articles 81 and 82 EC Treaty and the Merger Regulation) is directly applicable in Germany. It applies to anticompetitive practices that restrict trade within the European Union.

Cartel Prohibition

Article 81 EC Treaty prohibits all agreements between undertakings, decisions by associations of undertakings and concerted practices that may affect trade between EU Member States and restrict competition within the Common Market. Any agreement infringing this prohibition is, in principle, null and void.

Until May 1, 2004, the European Commission had the exclusive right to grant exemptions from the EU cartel prohibition on an individual or a general basis. Regulation 1/2003 has changed this system. The general exemption clause of Article 81 EC Treaty is now deemed to be self-executing; a formal clearance or any other administrative act by an authority is no longer necessary. Thus, all restrictive agreements are exempted from the cartel prohibition if they contribute to the improvement of production or distribution of goods or the promotion of technical or economic progress, while allowing consumers a fair share of the resulting benefit; they have to be indispensable and must not eliminate competition.

Furthermore, the block exemptions remain in force after May 1, 2004. Those agreements that fall within their scope are, as a rule, permitted. Horizontal block exemptions cover e.g. specialization and research and development agreements. For vertical restraints, there are several block exemptions. One covers the most frequent restrictions in vertical relationships (e.g. in distribution and in franchising contracts), another covers the distribution of motor vehicles, and a third one covers technology transfer agreements. There are also block exemptions for the transport and the insurance sector. The European Commission has issued horizontal and vertical guidelines in addition to the respective block exemptions mentioned above. In practice, it will in most cases be difficult to claim that an agreement that is not covered by a block exemption will fall under the general exemption clause of Article 81 EC Treaty.

Dominant Companies

Article 82 EC Treaty prohibits any abuse of a dominant position within the Common Market or in a substantial part thereof affecting trade between member states. Similar to the provisions of the GWB on dominant firms, first, the relevant market has to be identified, and, second, it has to be determined whether a company is actually dominant. In both instances the tests applied under European law are, by and large, the same as under the GWB. Typical cases of abuse are: imposition of unfair purchase or selling prices or unfair trading conditions, hindrance of another company in an unfair manner in business activities, esp. the refusal to provide a competitor access to one's own infrastructure (so-called essential facilities), and tying arrangements. In December 2005 the European Commission issued a discussion paper with respect to the application of Art. 82 EC Treaty, which emphasizes a more economic approach in the assessment of potentially abusive behaviour. It is not yet decided whether this discussion paper will lead to further guidelines by the European Commission.

Merger Control

The European Merger Control Regulation dates back to 1989 and has been amended as of May 1, 2004. The acquisition of control of one company over another ("concentration") must be notified if certain turnover thresholds are exceeded. A notification to the European Commission is required if:

- (i) the combined aggregate worldwide turnover of the companies involved exceeds 5 billion and (ii) the aggregate Community-wide turnover of each of at least two of the companies exceeds 250 million, or
- (i) the combined aggregate turnover exceeds 2.5 billion on a worldwide basis, (ii) the combined aggregate turnover of all companies concerned furthermore exceeds 100 million in each of at least three Member States and (iii) the aggregate turnover of each of at least two of the companies concerned exceeds 25 million in the aforementioned three Member States, (iv) the aggregate Community-wide turnover of each of at least two of the companies concerned exceeds 100 million.

Even if a concentration fulfills these criteria, the Regulation will not apply if each of the companies concerned achieves more than two-thirds of its aggregate Community-wide turnover in one and the same Member State.

If a concentration would significantly impede effective competition in the Common Market or in a substantial part thereof, the European Commission will prohibit it. This will be true in particular if the concentration creates or strengthens a dominant position. Similar to the GWB, the Merger Regulation provides for a procedure in two phases: within 25 working days after receipt of the complete notification the European Commission has to decide whether it intends to initiate a closer investigation. It must, as a rule, pass a final decision within 90 working days after the procedure has begun.

Dr. Helmut Janssen, LL.M.
helmut.janssen@luther-lawfirm.com

Dr. Thomas Kapp, LL.M.
thomas.kapp@luther-lawfirm.com