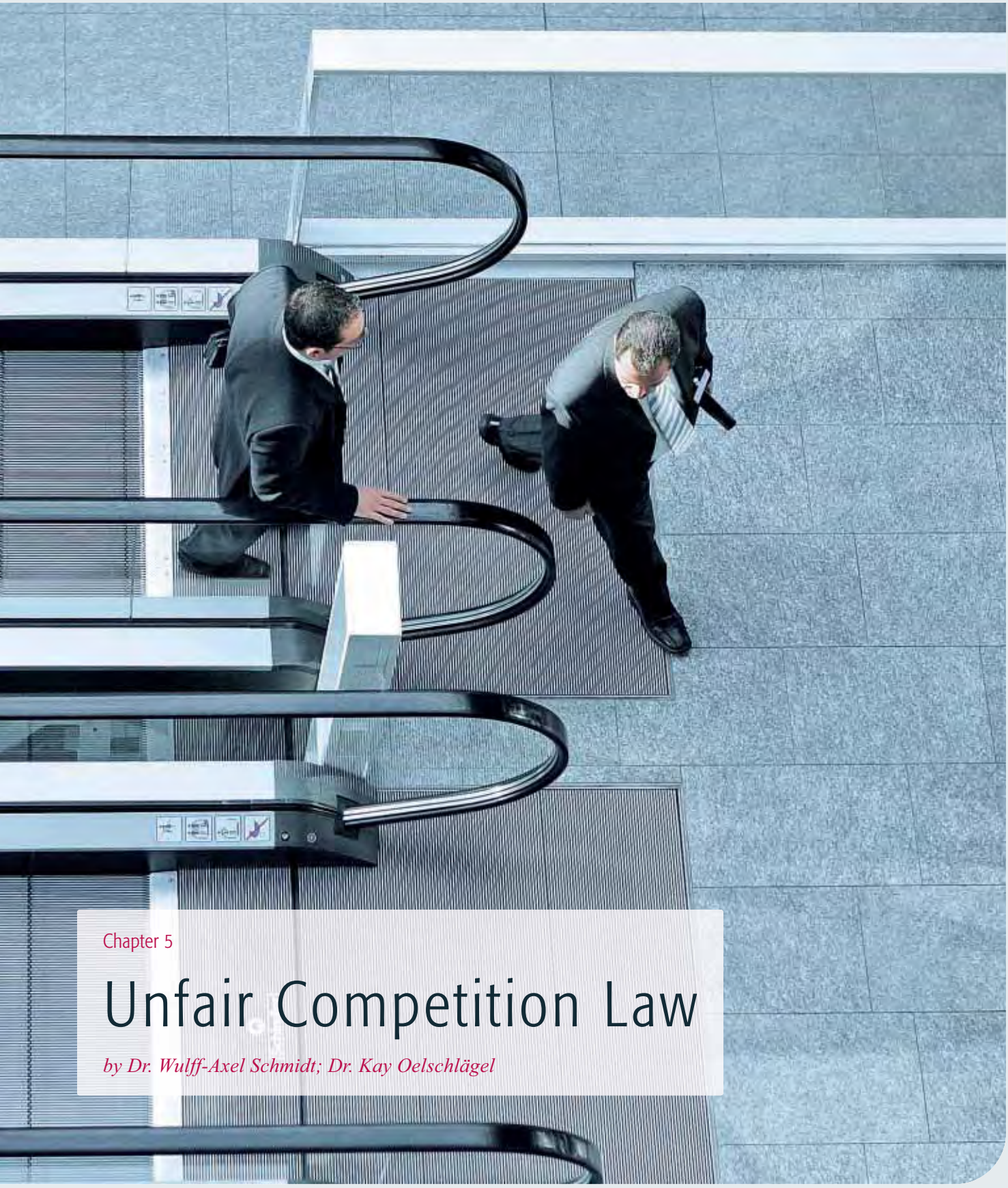

Chapter 5

Unfair Competition Law

by Dr. Wulff-Axel Schmidt; Dr. Kay Oelschlägel

The goal of unfair competition law is to protect free competition for the benefit of participants in trade or business. Protection of free competition is basically set forth by the Act Against Unfair Practices (Gesetz gegen den unlauteren Wettbewerb, UWG).

In comparison to other European unfair competition laws, the German Act Against Unfair Practices is quite restrictive. The law itself mainly provides general legal guidelines so that case law has had to fill in the gaps that the law left unaddressed. Consequently, the courts have categorized unfair trade practices into various types, in particular into unfair influence on customers and unfair restraint of competitors. To some extent, these categories have been implemented into the latest version of the UWG, which entered into force on July 8, 2004.

In 2004, the UWG was thoroughly revised aiming at the modernization of German law against unfair practices, in particular deregulating the market, and bringing it into line with developments under EU law. The revised UWG aims to protect competitors, consumers, and other market participants against unfair acts in competition, as well as the interests of the general public in undistorted competition (Sec. 1). In particular, the new Act provides a list of definitions of important terms (Sec. 2) and lists of conduct regarded to be unfair to complement the general clauses (Sec. 4 and 5).

The most important changes were the implementation of a legally relevant threshold in Sec. 3 UWG, the explicit examples of unfair practices in Secs. 4 and 5 UWG, the implementation of rules relating to direct marketing activities (Sec. 7) and (one of the most controversial discussed provisions) a provision that will allow skimming off excessive profits generated by actions deemed unfair by the UWG if numerous customers have been object of the unfair actions on purpose (Sec. 10 UWG). Furthermore, restrictions with regard to clearance and special sales have been deleted.

Act Against Unfair Practices

Sec. 3 UWG as general clause provides that, as a rule, unfair acts of competition are prohibited. Sec. 4 to 7 UWG contain lists of explicit examples of acts typically regarded to be unfair. However, the unfair practices listed in Sec. 4 to 7 UWG are not conclusive. It has to be decided on a case-by-case basis whether a commercial activity must be considered as an unfair practice. In particular, the provisions regarding deceptive advertisement are of importance in this regard, as they set forth that customers may not be misled by creating wrong perceptions with respect to the products, their quality, availability and origin as well as the reason and kind of the sale etc.

A person or entity who, in the course of conducting trade or business, acts contrary to the Act with competitive intent is subject not only to an action to cease and desist from such activity, but also to damages claims.

Unfair Influence on Customers

Competitors must, as a rule, advertise their products and services on the market without influencing a customer's independent judgment and free choice. Advertising statements regarding the quality, origin, price, and quantity of products and services must be true and correct and may not be misleading. The use of terms such as "the best" or "the largest" is forbidden if a material advantage as compared to all competitors cannot be proven. The use of indications of origin that cannot, in fact, be attributed to the products or services in question is likewise prohibited. Misleading product information may also be caused by the use of an allegedly "independent" third party opinion for advertising purposes if such party was not in fact acting independently from the advertising party. Misrepresentations of price can also arise where low-price products are offered for sale, either in insufficient quantity or not in fact at the low price listed in the advertisement.

Unfair influence on a customer is also possible if he or she is put under "psychological coercion" by a seller that infringes the customer's freedom to reach purchase decisions. A customer may be forced in such cases to purchase a product which he or she might otherwise not have been interested in as a result of an aggressive sales approach. This may occur, for example, if a customer has to enter a shop in order to receive a gift or if unordered goods are delivered. There are also strict regulations on certain aspects of sweepstakes or competitions in connection with products and services. These must be designed in a way that allows entries of non-customers without any discrimination, as long as they are not necessarily by nature connected to the sold product or service.

Sec. 7 UWG basically prohibits advertising via automated calling systems, e-mail and facsimile aimed at consumers who have not agreed to receive such advertisements. An exception applies to direct marketing via e-mail in already established customer relationships if the customer is given the option to decline any such advertisements at any time. Advertisement via e-mail in which the sender on whose behalf the communication is made is concealed or disguised, or in which no valid address to be contacted to request the termination of such communication is given, is prohibited. The Act has also increased the protection of advertising recipients by way of prohibiting any advertising that "obviously" is not desired by the recipient as well as all marketing by telephone calls in respect of private persons, who have not explicitly agreed in advance. Furthermore, all other customers must not be contacted if not at least an alleged assent can be assumed. With these regulations Germany has implemented a strict "Opt-In" procedure that severely limits the options of telephone-, faximile- and e-mail-marketing compared to other markets.

Unfair Restraint of Competitors

An unfair restraint of competitors can occur through destructive competition. Even if such unfair restraint results from the superior performance of a competitor, however, such activity may still be held to constitute an unfair practice if its intent is to obstruct or eliminate competitors or causes essential risks to free competition. The undercutting of prices may violate "good ethics", for example, if the seller acts with unfair intent. Free competition may furthermore be jeopardized by distributing free products on the market to a large extent. The reproduction of work products as well as the exploitation of a competitor's reputation may also be considered illegal under certain conditions.

With regard to comparative advertising, the Act provides that comparative advertising is allowed in principle under certain conditions as set forth in Sec. 6 UWG. Comparative advertising is basically permitted, for example, to make references to the quality of other goods and to name an obvious competitor. Having been restrictive in the past, German courts have nowadays adopted a more liberal approach towards comparative advertising.

Violation of Law

The interest of the general public may be affected by a violation of law. A violation of law other than those dealing directly with unfair practices may also be considered as an infringement of "good ethics" if the violation results from a competitive action and has an impact on competition. A violation of contract may furthermore be relevant under unfair competition rules, in particular with regard to distribution systems.

Other Specific Unfair Competition Regulations

In summer 2001, the Price Discounts Act (Rabattgesetz) and the Complementary Extras Regulation (Zugabeverordnung) that had restricted certain commercial promotion activities were abrogated. Consequently, the sellers' possibilities to offer rebates or to announce complementary extras have increased. However, the Act against Unfair Practices also sets standards with regard to such promotional activities.

Furthermore, the violation of laws aimed at protecting an important public interest may also constitute an unfair practice. In particular, laws related to public health, such as the Drug Law, the Drug Advertisement Act as well as some provisions of the Food and Daily Needs Act must be considered.

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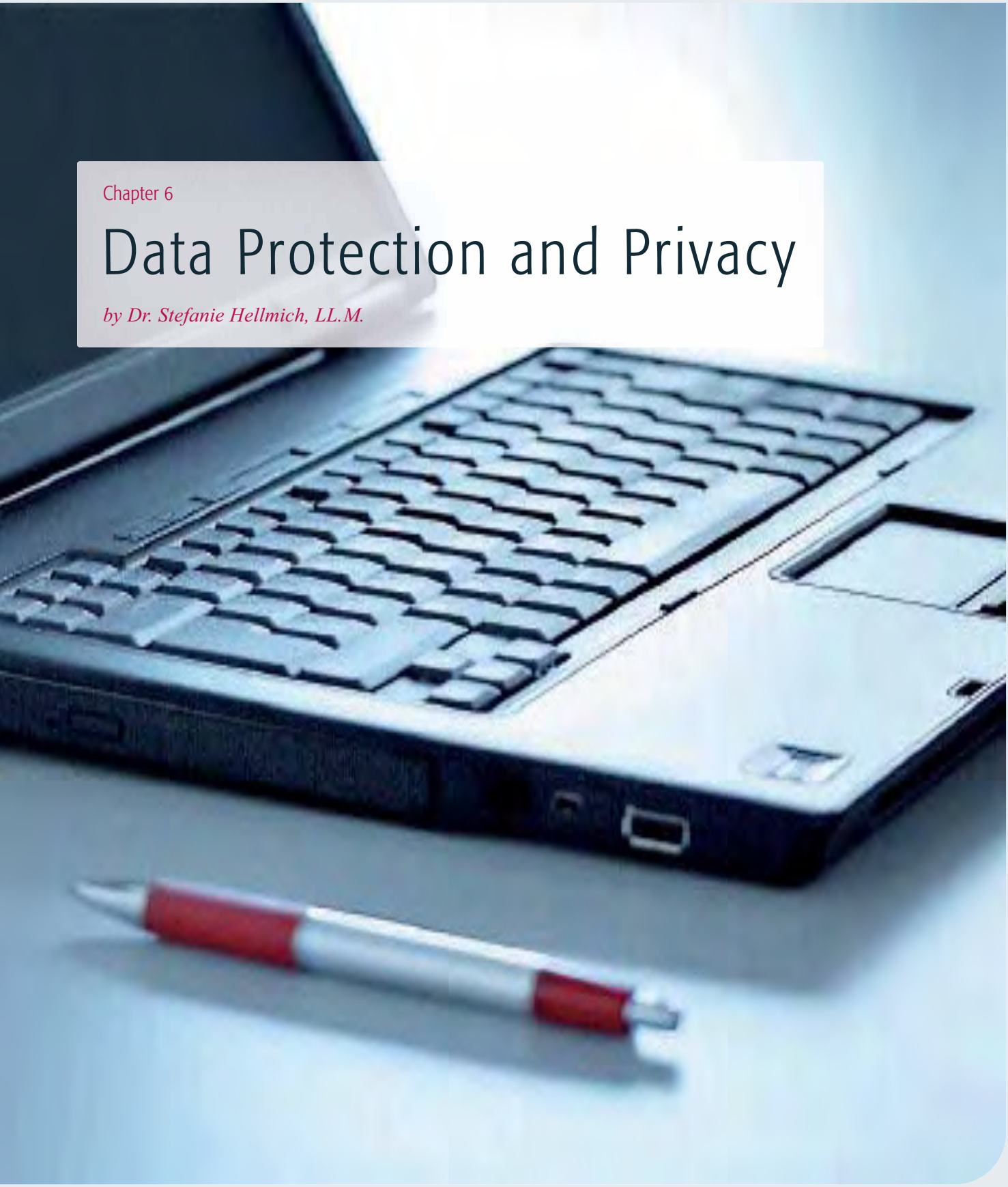

Chapter 6

Data Protection and Privacy

by Dr. Stefanie Hellmich, LL.M.

In Germany, the collection, processing and use of personally identifiable data ("personal data") is subject to the German Federal Data Protection Act (Bundesdatenschutzgesetz, BDSG) which is complemented by several specific acts regulating the protection of personal data in particularly sensitive areas, such as the telecommunications and media sector, the healthcare sector or the criminal prosecution sector. Insofar, the Teleservices Data Protection Act (Teledienstedatenschutzgesetz, TDDSG) and the Telecommunications Act (Telekommunikationsgesetz, TKG) for example contain specific legal requirements for the electronic processing of personal data.

Collection, Processing and Use of Personal Data

Basically, any collection, processing or use of personal data is lawful, provided that a statutory legal basis is available or the affected data subject has given his explicit consent. Such, personal data may be collected for contractual purposes for which the data have been provided or if the collecting party has a justified interest in collecting, processing and using such data and the affected data subject does not have an overriding legitimate interest in preventing such use. The collection, processing or use of special categories of personal data (such as data on racial origin or health) for a party's own business purposes is only lawful without the data subject's consent, if it is necessary in order to safeguard vital interests of the data subject or of a third party and if the data subject is physically or legally incapable of giving his consent; the data in question have manifestly been placed in the public domain by the data subject; it is necessary for the establishment, exercise or defence of legal claims and there are no grounds for believing that the data subject has an overriding legitimate interest in excluding the collection, processing or use, or if it is necessary for conducting scientific research and the scientific interest in carrying out the research project substantially outweighs the data subject's interest in precluding collection and the purpose of the research could not be achieved by other means without unreasonable effort or at all. As far as no statutory provision for the collection, processing or use of personal data is applicable, the explicit consent of the affected data subject is required. For obtaining a valid consent the data subject has to be informed extensively about each purpose for which its data will be collected, processed or used, i.e. for which purpose it will give its consent.

Transfer of Data outside EEA

The transfer of personal data towards entities located outside the European Economic Area is permitted only if the data subject does not have a legitimate interest in excluding such transfer. A legitimate interest to exclude a transfer is recognized especially if an adequate level of data protection is not guaranteed by the recipient. The adequacy of the afforded level of protection is to be assessed in the light of all circumstances of a data transfer.

In certain cases, however, a data transfer is permitted, irrespective of an adequate level of data protection. That is primarily the case if the consent of the data subject has been given or if the transfer is necessary for the performance of a contract. In addition, important public interests or the establishment, exercise or defence of legal claims or the protection of a vital interest of the data subject may justify a transfer, regardless of the level of protection afforded by the recipient to which the data is transferred. In addition, the supervisory authorities may authorize a transfer of personal data if an adequate standard of protection is ascertained by contractual means or by means of binding corporate rules.

Notification Requirements

Also, in principle the responsible state authority has to be notified of data processing activities in the private sector. However, such notification is principally not required if the controller has appointed a data protection officer. Only if the data processing activities bear a considerable risk of exposure, i.e. if personal data are stored for the purpose of transferring them or for the purpose of an anonymous transfer on a commercial basis, such activities necessarily have to be notified.

Sanctions

Offences against the data protection regulations may be punished with a fine of up to € 250,000 or imprisonment of up to two years. The affected data subjects may file a complaint with the supervisory authority. Individuals may also base a claim for damages if they can prove an actual damage by an unlawful processing of their personal data. Practically, the ability of competitors to file an injunction based on the illegal collection, processing or use of personal data in connection with a violation of unfair competition law rules has become increasingly important. In particular, concerning unsolicited communication the unfair competition law rules provide additional restrictions for the use of personal data.

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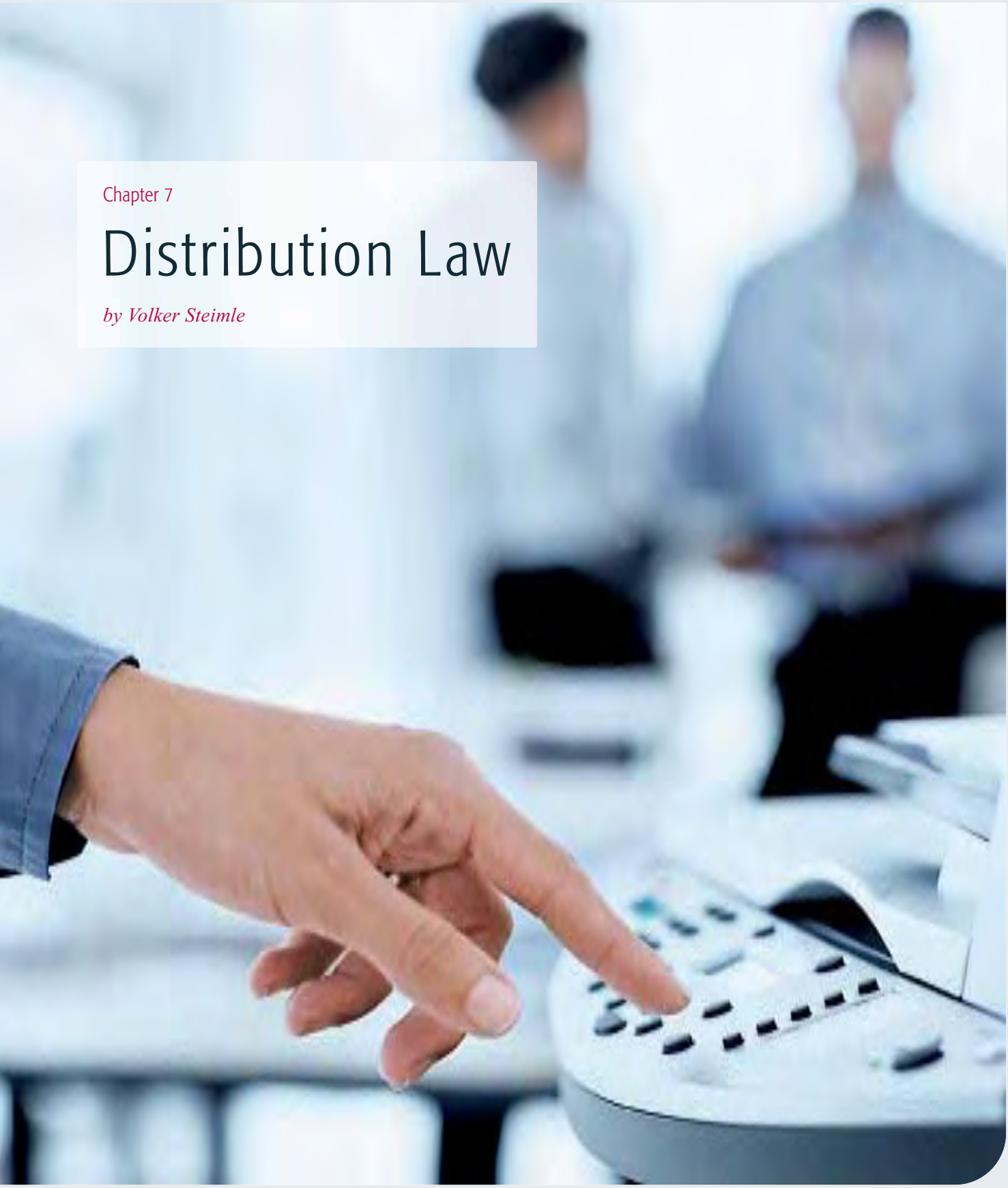

Chapter 7

Distribution Law

by Volker Steimle

German law offers a variety of possibilities and legal vehicles to a foreign manufacturer or service provider who wishes to distribute its products in Germany. The manufacturer may establish an own distribution company, which gives it the maximum influence on the behaviour of "its" distributor, e.g. pricing, selection criteria, service levels, sales personnel etc. in the foreign market. On the other hand, this entails not only considerable expenses, but also requires extensive organization and control. Another option is the sale of goods through independent traders in the meaning of a mere buyer/seller relationship (importers, wholesaler, retailers) – here, the manufacturer has no fixed costs so that there should be no risks or problems with the profitability of the distribution, but this means the loss of almost any influence on the handling of the distribution and the positioning of the brand. This lack of an effective coordination may damage the value of a brand and impair the manufacturer's business. The manufacturer must therefore balance control and influence on the distribution of its products, against participation in distribution costs and economic risks, when deciding which distribution channel ideally fits its purposes.

In order to avoid both extremes, in particular small to medium-sized manufacturing companies tend to engage independent sales intermediaries which are still subject to a certain degree of control. This relationship may be established as an exclusive one. Eventually, the distribution structure that meets best the objectives of a foreign company that wants to successfully enter the German market may not lose tax issues out of sight.

Overview

The most important types of distribution intermediaries in Germany are commercial agents (Handelsvertreter) and distributors (Händler). The use of franchisees and commission agents is also quite common. In general foreign suppliers are not subject to specific regulations with regard to their distribution channel. However, if they choose to not rely on a direct distribution but on the afore-mentioned independent sales intermediaries, a variety of mandatory rules have to be considered. German law provides regulations for commercial agents and commissionaires in Sec. 84 – 92c respectively Sec. 383 – 403 of the German Commercial Code (Handelsgesetzbuch, HGB). Besides, the law on commercial agents has been addressed and harmonized in the European Member States based on an EU Directive. Furthermore, there are special regulations for commercial agents who act as insurance agents in Secs. 43 – 47 of the Act on Insurance Contracts (Versicherungsvertragsgesetz, VVG). In spite of the practical importance, Germany and almost all other European countries still lack codification of distributor and franchising law.

The main difference between commercial agents and distributors is that commercial agents are only intermediates in transactions between the manufacturer and its customers concluded in the manufacturer's name and for its account, whereas a distributor purchases the contracting partner's products in a long-term business relationship and resells them in its own name and for its own account. As a result of this, the commercial agent's remuneration consists of either a commission or a fixed amount (or a combination thereof), while the distributor's remuneration consists usually of the profit it achieves resulting from the difference between the purchase and the sales price, i.e. typically the discounts and rebates granted to it by the manufacturer compared to the list price. Moreover, the fiduciary duties of a principal vis-à-vis its commercial agent are stronger compared to a distributor relationship, since the principal has more influence concerning the behaviour of the commercial agent in the market and the commercial agent therefore is supposed to be more dependant on protection.

The franchisee distinguishes from a commercial agent by selling goods or offering services in its own name and for its own account like a distributor. In contrast to a distributor, the franchisee is far more integrated into the organizational and advertising system provided by the franchisor, since it is entitled – but also obliged – to use brand, selling and production techniques developed by the franchisor and is typically subjected to a closely-knit contract system. The commission agent sells goods in its own name but for the account of the principal. Commissionaire agreements are not very widespread but are used where the intermediary has a strong position in a narrow market, e.g. in the financing sector, stock exchanges etc. They sometimes are used in order to optimize the tax burdens of intra-group supply chain management.

As a very rough guideline, one could say that a commercial agent provides for the highest degree of control by the principal, followed by the commissionaire and the franchisee. The least degree of control is provided by a distributor arrangement, however depending on whether exclusive or non-exclusive distribution is concerned. This situation is reflected by the allocation of business risks (e.g. the keeping and financing of inventories, after-sales obligations, obtaining of permits for the relevant products etc.) and – consequently – the profit margins typically to be granted to the intermediaries for the different distribution channels.

Commercial Agency

Conclusion of Contract

As a general rule, agency agreements do not require written form and can therefore also be concluded orally or even tacitly. However, the German Commercial Code (HGB) provides for two exceptions thereto. Firstly, a delcredere agreement, under which the commercial agent guarantees the fulfilment of the customer's obligations resulting from a transaction, must be concluded in writing according to Sec. 86 b HGB. Secondly, a post-contractual non-competition undertaking is only binding when in written form, cf. Sec. 90 a HGB.

Contractual Obligations of the Commercial Agent

The main obligation of the commercial agent is to seek to arrange the conclusion of transactions for the principal on an ongoing basis. Not only is it the undertaking of the commercial agent to maintain and increase the business with existing customers, but also to acquire new customers for the products of the principal and to regularly give reports thereon. The extent and limits of a commercial agent's activities largely depend on the contractual agreement.

In the absence of an explicit contractual agreement that provides else, German courts tend to accept an implied undertaking of the commercial agent not to represent competing manufacturers during the term of the agency agreement. However, this does not comprise a post-contractual restriction of competition which requires not only an explicit agreement thereon in written form, but is also restricted to a maximum duration of two years, starting on the date the contract was terminated. Moreover, to be valid such post-contractual non-competition undertaking needs to vest the commercial agent with a claim for a reasonable compensation during the period in which competition is restricted.

As a general principle, the commercial agent is obliged to obey the instructions of its principal. This applies to all respects of the distribution and allows the principal to e.g. fix the resale prices or any other terms to be agreed with the customers. Restrictions on this principle arise, as a general rule of thumb, if the parties have chosen the contractual vehicle of agency to circumvent the rules of cartel law. Further care has to be taken that the commercial agent's independence is not impermissibly impaired. Otherwise the commercial agent may be regarded as an employee of the principal, so that special labour law regulations will apply.

As an option, delcredere agreements and commitments to collect costumer receivables can be agreed. In particular, the conclusion of collection agreements often makes sense in cross-border agency agreements. The resident commercial agent residing within the relevant market is generally better positioned in this regard than the principal residing abroad, who is not necessarily familiar with local law and customs like payment habits. Besides, further duties, which are not provided by the German Commercial Code, can be agreed to some extent.

Contractual Obligations of the Principal

The German Commercial Code determines numerous obligations of the principal concerning the relationship with a commercial agent. The main obligation is to remunerate the commercial agent for the successful arrangement or conclusion of transactions. Remuneration may consist of either a commission, being a success fee, a fixed remuneration or a combination thereof (a so-called guaranteed commission). Unless explicitly agreed otherwise, the commission is only to be paid if a contract with the customers is eventually concluded and if the customer under the relevant contract pays the purchase price. If the commercial agent is granted a guaranteed contractual territory ("Bezirksvertretung"), the commission is due irrespective of whether the contract with the customer was actually concluded or arranged by the agent or not. It is in the principal's interest to avoid this by way of relevant provisions in an agency contract. In case of a fixed commission, the commercial agent is promised a minimum commission irrespective of its business results. Since the principal here incurs costs, irrespective of whether the commercial agent is successful or not, it is more common to agree on a commission which depends on concrete business results. A guaranteed or fixed commission however may be suitable for the period during which business relations are being built up in new sales territories.

Special problems may arise regarding commissions which are based on sales that have been arranged during the effectiveness of the agency agreement but put into execution only after the ending of said agreement (so called overhang commissions) or when the transaction concluded or arranged by the agent consists of a long-term framework agreement with the customer, which survives the duration of the agency agreement.

Alongside the obligation to remunerate the commercial agent for its activities, the principal is committed to give necessary information to its commercial agent. Besides, the importance of fiduciary duties may not be underestimated. The principal has to support the fulfilment of the commercial agent's obligations and has to refrain from doing anything that might conflict with the commercial agent's interests, to the extent reasonable.

Tax problems regarding the commission have to be considered when an affiliated company of the principal performs the distribution. In that case, the "arm's length" doctrine requires special tailoring of the relevant conditions.

Ending the Contractual Relationship

A contractual relationship concluded for a specific period ends upon expiry of the period. An agreement of indefinite duration usually ends by termination under observation of a statutory notice period based on the length of time the agreement existed. The period ranges from one month in the first year to a maximum of six months from the fifth year onwards. It may be extended by contractual agreement, but not shortened. If the periods of notice are extended, they may not be longer for the commercial agent than for the principal. A cancellation agreement to which no notice period applies is also possible.

The contractual relationship may also be terminated for good cause at any time, without observing a notice period. In the latter case, it is crucial that the terminating party cannot reasonably be expected to continue the contractual relationship until the end of the afore-mentioned period. Typical examples include the commercial agent representing a competing company or the principal repeatedly breaching its obligation to pay commission. If the contractual relationship is terminated validly for good cause by the principal, because of a breach of contract of the agent, however, the commercial agent usually loses its claim to compensation (cf. below).

Compensation Claims

The commercial agent is entitled to compensation after the termination of the contractual relationship for those recurrent new customers acquired by it during the term of the contract, Sec. 89b HGB. This applies as well to those recurrent customers, with which the agent has significantly increased an existing customer relationship. The purpose of this provision is to remunerate the commercial agent for the customer base acquired by it, for the benefit of the principal and to the extent it is of lasting value to the latter. The claim to compensation cannot be waived by the agent or otherwise be contractually derogated and is only excluded in limited circumstances, in particular if the commercial agent terminated the agreement itself, other than for good cause, or if the principal terminated it for good cause within the responsibility of the agent.

The commercial agent receives as compensation such commissions he would have earned from future transactions with those recurrent customers that have been acquired, intensified or reactivated by it. The calculation of the compensation is often very difficult. Furthermore, it has to be considered that there are special circumstances, which may reduce the claim in good faith – here; in particular, the “bandwagon effect of the brand” is relevant. The claim is, however, limited and may not exceed the average annual commission based on the last five years of the commercial agent’s activities. In practice, this cap usually determines the amount of the compensation claim to be paid.

Choice of the Governing Law

If the commercial agent and the principal reside in different countries it is advisable to agree on the law governing the agreement and the choice of forum in advance. Otherwise usually the national law of the commercial agent’s seat or headquarters applies.

Certain limits are, however, imposed on the choice of the applicable law. As most other national laws do, German law provides for a number of regulations which apply to contracts irrespective of the law chosen. This principle has been emphasized by a recent ruling of the European Court of Justice and restricts the effects of a choice of non EU-laws. In particular, the protection of the agent concerning the commercial agent’s claim to remuneration, the claim to compensation as well as the minimum notice periods for termination have to be considered, since these have been harmonised throughout the EU.

A different approach is possible according to Sec. 92c HGB, however, if the commercial agent performs its activities solely outside the territory of the European Union or the European Economic Area. In the latter case, Sec. 92c HGB thus allows to derogate also mandatory regulations of the German Commercial Code, e.g. the compensation claims, shorter notice periods etc.

Distributors

Distribution Agreement

The distribution contract is defined as a framework agreement under which the distributor is obliged to sell goods of the manufacturer in its own name and for its own account, thereby being integrated into the sales organization of the manufacturer. Again, such agreement can be concluded informally, i.e. orally or tacitly. Compared to a commercial agent the distributor is usually less restrained by instructions of the principal but, on the other hand, he generally takes over more obligations like maintaining a warehouse, a stock of spare parts or providing after-sales services.

Alongside the obligation to remuneration, which is typically granted by way of a dealer's margin/dealer's discount, the contractual obligations of the principal are comparable to those of the principal of a commercial agent if the distributor is equivalently integrated into the sales organization of the principal.

A territorial protection or exclusivity clause is often included in distribution agreements, providing that only the distributor may sell the manufacturer's products in the contractual territory. Since such clauses prevent a manufacturer from appointing other distributors in a certain territory or from concluding transactions directly and therefore may impair competition, they require exemption, regularly under European competition law. Even if the parties agree on an exclusivity clause, it is not unusual for a manufacturer to reserve the right to supply certain major customers with whom business relations already existed before concluding the distribution agreement.

Distribution systems between non-competing companies are widely covered by the EU-Block Exemption Regulation for Vertical Restraints (Vertikal-Gruppenfreistellungsverordnung), which applies to products and services in all industries except for motor vehicle distribution and technology transfer, which are governed by own special Block Exemption Regulations. If the share of the supplier (for exclusive purchase agreements: of the buyer) in the relevant market does not exceed 30 per cent, most of the vertical restraints of competition are exempted by law from the general prohibition of restraints of trade. Some particularly restrictive clauses, however, are "blacklisted" and do not benefit from said exemption (e.g. minimum or fixed resale price maintenance, granting of excessive territorial protection and certain other restraints of inter-brand or intra-brand competition). Non-competition clauses, which also include exclusive purchasing agreements, may not exceed five years duration. Agreements that are not covered by the Block Exemption (e.g. because the market share threshold is exceeded) but are as well not "blacklisted" may be applied for an individual exemption or a comfort letter.

German competition law, which applies as well to cases that are purely domestic, has been harmonised with the European scheme recently. As a result, German competition law is less restrictive than in the past and the parties have more freedom in forming their distribution contracts, e.g. on recommended retail prices or most preferred customer clauses.

Ending the Contractual Relationship

A distribution agreement concluded for a specific period ends upon expiry of the specified period. An agreement not limited by time can be ended by termination for good cause at any time, without observing a notice period. Resulting from the lack of codification of the law of distributorship, problems arise concerning the question which notice period applies when there is no good cause for the termination. German courts have a tendency to decide that the period of notice for a distributor contract needs to be longer than the one for an agency contract, because the distributor is often forced to undertake relatively high investments, which would be devalued by the possibility of a short notice period. Therefore, a minimum notice period for termination of one year is considered reasonable in most cases (exclusive distributorship). Longer periods may be required depending on the industry and the duration of the contractual relationship. Two years may be required, for example, for the distribution of motor vehicles based on the relevant EU Block Exemption Regulation.

Claim to Compensation / Obligation to Repurchase Delivered Products

With the ending of a distribution agreement the particularly important issue is whether, as with commercial agents, a distributor can claim compensation for those recurrent customers it acquired during the term of the agreement. German courts have generally held this to be the case if the status of the distributor is equivalent to the relationship between a commercial agent and its principal. Thereby, no claim for compensation exists if the contractual relationship does not exceed a mere seller-vendor relationship. In practice, the decisive question here is whether the distributor is contractually obliged to disclose his customer base to the principal.

The principles for the calculation of the compensation are in most parts comparable with those applicable to a commercial agency agreement. However, there is a difference concerning the calculation basis. The claim to compensation of a commercial agent is based on its commission. The dealer's margin, by contrast, contains also remuneration for activities which are usually not taken over by a commercial agent, e.g. after-sales, financing of inventories etc. This part of the dealer's margin does not have to be compensated for, i.e. the dealer's margin has to be reduced to the level of an agent's commission for the purpose of calculating the compensation claim.

For the calculation of the compensation the problem of the "bandwagon effect of the brand" is even more acute than in an agency agreement. The success of a product in the market does not solely depend on the dealer's selling skills and efforts but also on the customer's general experience with products of the relevant brand and on centrally controlled advertising campaigns of the principal. This may result in a mitigation of the compensation claims. In any case, if the distributor was committed to keep a minimum of products in stock during the term of the contract the principal is obliged to repurchase the remaining goods in stock after the end of the contract.

Choice of Law

Similar questions apply here as already pointed out with regard to the commercial agent. There are, however, further uncertainties since the law of distributorship is not codified in Germany.

Franchise Agreements

Franchising is a contractual method for marketing and distributing goods and services of a company through a dedicated or restricted network of distributors. Ideally, it is a contractual relationship between a principal with a proven business system and an ambitious "independent" distributor willing to follow its system. It is most successful where homogenous goods or services can be offered in large quantities under a joint brand that penetrates the consumer consciousness. The franchisee constitutes an independent entity even if it appears to be part of the franchisor and the same legal principles are applicable as with commission agents and distributors. Because of this, it is the prevailing opinion that under German law a franchisee may claim compensation similar to that of a commercial agent or a distributor after the end of the contractual relationship – German courts, however, have not finally decided this question yet.

The aforementioned Block Exemption Regulation for vertical relationships also governs franchise agreements in terms of cartel law. There remain, however, a number of issues of concern under this new regulation including exclusivity and non-competition clauses.

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Chapter 8

Industrial Relations and Labour Legislation

by Hans-Christian Ackermann; Martina Buhr

Two national employer organizations exist, the Confederation of German Employers (Bundesvereinigung der Deutschen Arbeitgeberverbände, BDA), which is concerned with social policies and the Federation of German Industry (Bundesverband der Deutschen Industrie, BDI), which deals with economic and commercial affairs.

The German Trade Union Federation (Deutscher Gewerkschaftsbund, DGB) is the major union federation with 8 member unions covering workers in all major industries. The biggest single union is ver.di with over 2.4 million members. Ver.di is a combination of five formerly independent unions, mainly representing white-collar employees.

Labour relations operate within a legal framework covered, for the most part, by the German Civil Code and several employee protection laws. Collective bargaining is carried out on a national or industry-wide level, as well as on a regional or local level. Said agreements apply only to those employers and employees who are members of the respective employer organization respectively trade union unless the agreement is declared to be generally binding by the Federal Department for Labor and Social Affairs. Some 456 collective bargaining agreements of a total of 64,300 are currently declared to be generally binding. The climate of labor relations in Germany is generally calm and stable, with a high degree of cooperation existing between management and trade unions.

Works Councils and Co-Determination

Works councils (Betriebsräte, i.e., committees of employee representatives) must be formed in all companies with five or more employees, if the employees request so. Members are elected for four years and need not be union members. The rights of the works council, as set forth in the Works Constitution Act (Betriebsverfassungsgesetz), range from information rights to co-determination rights in organizational, social and economic matters. In social matters, the employer is obligated to negotiate rules with the works council on the allocation of working hours, vacation schedules, grievances and matters of safety and welfare. The works council must be informed prior to the dismissal of any employee. The employer and the works council must, under certain circumstances, negotiate a reconciliation of interests (Interessenausgleich) and a social compensation plan (Sozialplan) in the case of mass redundancies or major restructuring, in order to compensate employees for the actual and financial disadvantages suffered as a result of the restructuring.

Co-determination was originally introduced in the iron, steel and coal industries in 1951 and provides for representation of workers on the supervisory board of certain corporations. The most important co-determination laws are the Act on One-Third-Participation (Drittelbeteiligungsgesetz) and the Co-determination Act 1976 (Mitbestimmungsgesetz).

The Act on One-Third-Participation, which replaced the former Works Constitution Act 1952 as of July 1, 2004, provides that all GmbHs and AGs with more than 500 employees, as well as all AGs, irrespective of their work force, if registered in the Commercial Register prior to August 10, 1994 and not family-owned must allow employees to elect one third of the members on the supervisory board.

The Co-determination Act 1976 requires that all companies with more than 2,000 employees must give employees equal representation with shareholders on the supervisory board. Employee representatives must include at least one management employee representative. The chairman (usually a representative of the shareholders) has the casting vote in the event of a tie.

Deemed Employees

According to the rulings of the Federal Labour Court, a person who is personally dependent on an employer is regarded as an employee. Such personal dependence is deemed to exist, either in view of the integration of the employee into the employer's operations or because the person is bound by employer's directions as to time, place and kind of services performed. In case of deemed employees the (actual) employer additionally faces substantial risks with respect to tax (wage withholding and VAT) and social security contributions.

Employment Contracts

No requirement exists for employment contracts to be in writing to be valid. The Law of Proof of Substantial Conditions Applicable to the Employment Relationship (so-called Nachweisgesetz) provides, however, that an employer must provide in writing the essential provisions of an employment relationship within one month after concluding an employment agreement. This document must include the name and address of the parties, the date of commencement, a job description including the place of work, the salary including any additional payment, the working hours, the vacation claim, notice periods and a reference to the applicable collective bargaining agreements and shop agreements.

The parties may agree on a probationary period for the employment agreement (which usually ranges from three to six months), pursuant to which the employment agreement may be terminated without reason at short notice, which must be at least two weeks.

In order to prevent an employer from circumventing employment protection provisions, fixed-term contracts are only permitted if an objective reason for the limitation of an employment term exists, or in case of new hires, where the term of an employment contract does not exceed a maximum period of two years, or is extended within said two year period up to three times. In case of a newly established business within its first four years, the term for new hires is up to four years.

Wages, Salaries and Bonuses

Law in Germany prescribes no minimum wage. Minimum wages are, however, often fixed by collective bargaining agreements in different industries. Equal pay legislation exists on a federal level providing equal pay for men and women. Although not a legal requirement, a thirteenth month salary/bonus is quite often paid at Christmas (or split between Christmas and vacation time).

Working Hours

The general legal maximum is 48 hours per week (based on a six-day working week), which can be extended up to 60 hours provided, however, within six months or 24 weeks the average will not exceed 8 hours per day. Based on a five-day working week the normal daily working time could be up to 9.6 hours (= 48:5). Trade unions are lobbying for a 35-hour week and collective bargaining agreements often provide for a shorter weekly working time (e.g. 38.5-hour week). Over-time is strongly opposed by unions.

Holidays and Vacation

All German states recognize the following public holidays: New Year's Day (January 1), Good Friday, Easter Monday, May Day (May 1), Ascension Day, Whit Monday, German Unity Day (October 3), Christmas Day (December 25), Boxing Day (December 26). Certain religious holidays exist in addition thereto which differ from state to state.

The minimum legal vacation is 20 working days annually (based on a five-day working-week) after completing six months of employment. Collective bargaining agreements as well as individual employment contracts usually increase the number of vacation days (often up to 30 days or more per year) while state laws provide for leave for special purposes (i.e., educational leave). An employee is entitled to receive vacation pay equal to his or her current salary during vacation. Several collective bargaining agreements, as well as business practice, provide for an extra vacation bonus.

Statutory Sick Pay

An employee is entitled to sick pay in case sickness stops the employee from performing his or her duties. Sick pay amounts to 100 per cent of normal salary and is received until recovery, but not beyond a period of six weeks (for the particular disease) beyond which time the employee, if eligible, receives benefits from the state health insurance plan.

Dismissal

The employer's right to issue a notice of termination may be restricted by individual contracts, collective bargaining agreements or by statute such as the Employment Protection Act 1969 (Kündigungsschutzgesetz, KSchG).

The statutory period of notice for termination for an employee during the first two years of employment with the same firm or plant is four weeks to the fifteenth or the end of a calendar month. If an employee has worked two or more years in the same firm or plant, the period of notice to be observed by the employers is one month to the end of a calendar month. The longer the employment relationship lasts, the longer is the period of notice required (up to a maximum of seven months, if the employment lasts for 20 years or more). The statutory notice requirements apply to the extent that no specific contractual notice period exists, or said period is invalid, due to the fact that it does not meet the statutory minimum. Any notice of termination must be given in writing, which requires an original signature. The same applies to the conclusion of settlement agreements. A notice of termination sent by fax is therefore insufficient.

The employment relationship can be terminated for cause, without notice, by either party for an important reason, which makes it unacceptable for the other party to continue the employment relationship until the expiry of the ordinary notice period. Termination for an important reason is only possible within the first two weeks of obtaining knowledge thereof.

The Employment Protection Act further provides that giving notice without an important reason to an employee who has worked in the same company for more than six months is only legally effective to the extent it is socially justified. The Employment Protection Act only applies, however, if the plant or shop regularly employs more than ten (before January 1, 2004: five) individuals, based on full-time positions. Employees who were covered by the Employment Protection Act before January 1, 2004 are not affected by the raising of the threshold. For new hires, however, the Employment Protection Act only applies if the threshold of ten employees is exceeded. Part-time positions are only counted proportionally (up to 20 hours per week = 0.5; up to 30 hours per week = 0.75).

Social justification within the meaning of the Employment Protection Act is limited to three principal areas.

Firstly, the termination of employment may be due to the personal circumstances of the employee such as a series of short-term illnesses or a long-term illness.

Secondly, the behaviour of the employee may constitute social justification for termination, i.e. being absent from work without excuse, despite repeated warnings or refusal to work. Prior to issuing a notice of termination in such cases, the employer has to give a warning to the employee with regard to his or her shortcomings.

Thirdly, a dismissal may be socially justified if based on operational reasons. In particular, this can be based on changes in the employer's business organization resulting in redundancy of the relevant job due, for example, to a plant closing or reduction of the work force due to a shortage of orders. However, the employer has to apply the so called "social factor method" considering the social data (age, seniority, maintenance obligation, severe disability) in order to principally select those employees for dismissal first, who are the "least disadvantaged" by the redundancy. The employee has the right to challenge said notice and to file a cause of action for re-employment with the competent labour court within a three-week period after receiving the notice. There is no statutory obligation of the employer to provide for a severance payment.

The termination of an employment relationship under the Employment Protection Act is usually complicated and often results in paying off the employee through a settlement agreement. As a general and rough rule, an average severance payment amounts to 50 per cent of the monthly gross salary for each year of service.

Additional employment protection exists for works council members, disabled employees, pregnant employees and employees on educational leave; said employees may not be terminated except for cause. Any termination, however, requires the prior consent of the competent authorities.

Maternity Rights

Any notice of termination issued during pregnancy and up to four months after the birth of a child is null and void to the extent that the employer was informed of the pregnancy within two weeks after issuing the termination letter. If continued employment is harmful to the health of the prospective mother or unborn baby as well as during the last six weeks of pregnancy and for eight weeks after a birth the mother must not work. Additionally pregnant employees may not work overtime, nights, on Sundays, or on public holidays.

Childcare Leave

Childcare leave is available for either parent or alternatively for both working part-time and may be taken for up to three years after a child is born. A parent taking childcare leave may not be dismissed from employment during this period, but must give notice to the employer three months before the end of the leave regarding his/her intention whether or not to return to work. Parents may alternate childcare leave up to three times during the three-year period.

Requirement to Employ the Disabled

Companies with more than 20 employees must have a workforce consisting of at least 5 per cent of individuals who are at least 50 per cent disabled. Employers who do not meet these hiring requirements are subject to a monthly charge up to € 260.00 per disabled employee not hired. Companies with more than five disabled employees may elect a disabled employees' representative. Disabled workers are entitled to five additional days of leave annually and enjoy special protection against dismissal.

Right of Reduction

In addition, employees who have been employed for more than six months are entitled to a reduction of their working time and weekly allocation, provided, however, the request does not contradict with legitimate operational interest of the employer (e.g. no suitable substitute employee available). However, in order to avoid an automatic change of the working time and allocation the employer has to reject employer's request in writing at the latest one month before the changes should become effective.

Transfer of Undertaking

Pursuant to the EU Directive on the transfer of undertakings and respective national regulation the transfer of a business or parts of it results in the legal transfer of the transferring party's employment relationships to the acquiring party. The same applies if – after a share acquisition – the new owner decides to move (change ownership) a business from one subsidiary to another. There is the risk that the potential closedown of an operation after a share purchase may actually be deemed in law to be a transfer of undertaking.

The transfer of undertaking (change of ownership of assets) results in the legal transfer of the existing employment agreements including all mutual rights and obligations. In case of pension, that depends on the national laws implementing the directive. For example German Law (sec. 613 a Civil Code) provides also for the legal transfer of pensions rights/expectancies of active employees, whereas the rights of pensioners remain with the transferring party.

According to German Law the further proceeding therefore depends on whether employees consent or object the transfer of their employments. Since a termination of employment is null and void if it is based on a transfer of undertaking the employees must be informed in writing about the indented transfer, the (planned) date of the transfer, the legal, economic and social consequences of the transfer for the employees as well as about any measures planned with respect to the employees. With this respect the employee is entitled to object the transfer, its reason and its consequences for the employees and their representatives within one month, after having obtained full written information of the transfer. If the employee objects to the transfer of employment, the employer may provide for ordinary notice (redundancy) based on the fact that the current position is transferred. With respect to such and other terminations the Employment Protection Act applies to all operations with more than ten (formerly five) regular employees.

In collective labour law there is a distinction to be made depending on the company is to be transferred in its entirety or in parts. If the entire company is to be transferred, the company identity is maintained and the old regulations remain valid. If the company identity is not maintained, however, the company agreements are transformed into individual rights together with a one-year barrier to change. New company agreements are, however, possible. The members of the works council lose their function when the company (division) is transferred but retain lasting protection against dismissal. However, for a transitional period of six months the former works council remains competent and responsible for starting new elections in order to create a works council in the transferred part.

Social Security

Germany has a compulsory social security system that covers five principle areas: health and nursing care insurance, old-age benefits, unemployment benefits and workers' compensation. Contributions to the social security system are generally shared equally between the employer and employee. The employer withholds the employee's share of the contribution from the employee's salary and pays this, together with its own contribution, to the Federal Insurance Agency.

Health Insurance

Benefits from public health insurance include the payment of medical and hospital expenses and compensation for loss of salary. Contributions to the public health insurance system are only payable up to certain salary levels, which are usually increased annually. As of January 1, 2006, only employees with a gross salary not exceeding € 47,250 annually or € 3,937.50 monthly ("Insurance Threshold"; Versicherungspflichtgrenze) are obligated by law to make contributions to the public health insurance system. No compulsory health insurance exists beyond these salary thresholds; employees exceeding said thresholds might therefore opt to maintain a private health insurance, to continue the participation in the public health insurance system or to have no health insurance at all (which is rare). Employees, who have not been subject to compulsory health insurance in 2002 and who have had a private health insurance as of December 2002, are entitled to keep their private health insurance, as long as their gross annual salary amounts to at least € 42,750; otherwise they become subject to compulsory health insurance.

The exact rate of compulsory health insurance depends on the individual insurance company but usually amounts to approximately 13.4 per cent of gross salary, capped by the „Income Threshold" (Beitragsbemessungsgrenze) amounting to currently € 42,750 annually or € 3,562.50 monthly (see above). If the employee is not subject to compulsory health insurance, the employer must contribute up to € 238.69 per month (50 per cent of the official average premium) to the employee's private health insurance.

Employers, who employ up to 20 employees may claim a refund for compensation paid to employees for sick or maternity leave, up to 80 per cent, from the competent health insurance.

Nursing Care Insurance

Contributions to the nursing care insurance plan amount to 1.7 per cent of gross salary capped again at the income threshold of € 42,750 annually or € 3,562.50 monthly. If the employee is not subject to compulsory health insurance, the employer must contribute up to € 30.28 per month (50 per cent of the official average premium) to the employee's private nursing care insurance.

Old-Age Benefits

Old-age contributions are currently levied at a rate of 19.5 per cent of gross salary capped at € 63,000 annually or € 5,250 monthly (western part of Germany) and € 52,800 annually or € 4,400 monthly (eastern part of Germany).

Unemployment Benefits

Unemployment insurance contributions amount to 6.5 per cent of gross salary capped as well at € 63,000 annually or € 5,250 monthly (respectively € 52,800 annually/€ 4,400 monthly in the Eastern part of Germany).

Workers' Compensation

The workers' compensation system is administered by associations (Berufsgenossenschaften) set up by all branches of trade and industry. Contributions to the workers' compensation system are made solely by the employer. The contribution amount is fixed by the various trade industry associations under consideration of the risk of a work accident occurring in the particular branch, the record of work accidents during the previous business year, and the total annual pay of all employees affected.

Insignificant Employment

The government introduced legislation on "Insignificant Employment" (positions with a salary of € 400.00 or less) as of April 1, 2003 pursuant to which employers must pay with effect as of July 1, 2006 a 30 per cent lump-sum charge on income of € 400.00 or less, which is tax-free for the employee. The 30 per cent is divided into 15 per cent for the statutory pension system, 13 per cent for health insurance and 2 per cent for a lump-sum tax (including church tax and solidarity tax). The employee, however, is not actually entitled to either health insurance or statutory pension benefits. With regard to statutory pension benefits, an employee may opt for membership in which case the employee must contribute the difference between the 15 per cent payment made by the employer and the statutory pension insurance contribution payable (currently 19.5 per cent) to the statutory pension system. The employee does not have this option with regard to health insurance. In order to promote so-called "household employment", the lump-sum charge only amounts to a total of 12 per cent for employment in private households and is divided into 5 per cent each for the statutory pension insurance scheme and health insurance and 2 per cent for the lump-sum tax stated above. The above stated option with regard to statutory pension benefits also applies. To certain extend (max. € 2,400.00 p.a.) expenses for "household employment" can also be deducted from the tax liability.

A progressive regime for income between € 400.01 and € 800.00 is introduced in order to remove the so-called low wage threshold and the sharp increase in social insurance contributions, which it caused. The employee's contribution varies here from 4 per cent through 21 per cent while the employer's share remains unchanged (i.e. currently approx. 21 per cent). The income tax is determined on an individual basis. Several "insignificant employment" jobs are generally added together. In order to facilitate the payment procedure, the contributions are all paid to a common collection point at the Federal Miners' Insurance (Bundesknappschaft) in Cottbus.

Anti Discrimination Act

Germany is obliged to transform four European Directives, which regulate protection against discrimination. These regulations concern several areas of the German legislation. The main focus is in the area of employment law and civil law, the latter means relationships between private persons, especially purchase, service, insurance and rental agreements. The Anti Discrimination Act (Allgemeines Gleichbehandlungsgesetz, AGG) has come into force as of August 18, 2006.

The main focus of the Anti Discrimination Act is the protection of discrimination for employed as well as self-employed personnel. The Anti Discrimination Act provides in section 1, that no discrimination must take place with regard to race and ethic, sex, religion or world view, disability, age and sexual identity. With respect to discrimination in view of the mentioned criteria, it has furthermore to be distinguished between direct and indirect discrimination.

Employees affected by discrimination are entitled to raise a claim at the competent position (e. g. employer, supervisor or workers' representatives). Within this claim the employee has to explain and accredit that and how he has been discriminated. The claim results in compensation of any material and immaterial damages resulting out of the discrimination.

Any rights due to the Anti Discrimination Act are individual claims of the employees, which can also be claimed in front of the competent labor court. With that respect the employee must raise any claim within three months after becoming aware of the discrimination. The labor court then has to evaluate, whether the claim of the employee is convincing, with the result that the employer in a second step has to justify the measures as accused by the employee.

Discrimination, however, shall be justified under certain circumstances such as for reason based on professional requirements, for reasons based on religion or world view, for reasons based on age and in order to balance already existing disadvantages. With respect to professional requirements discrimination shall be justified, if the criteria represent an essential and decisive professional requirement and the purpose is therefore as well legitimate as the requirement appropriate.

Regarding discrimination due to age such shall be justified if appropriate and justified by legitimate purposes as expressively set forth in section 10 of the Anti Discrimination Act, such as taking into consideration the age with respect to any social election in case of business related terminations.

With respect to churches and religious communities, these shall further on be entitled to select their employees by taking into consideration their religion or world view, as far as such is justified with respect to the right of self-determination of these institutions. Finally, discrimination shall also be justified if resulting into the balancing of already existing disadvantages, e.g. preference of elderly or disabled persons in case of engagements.

The Anti Discrimination Act further provides for co-determination rights of so-called Anti Discrimination Organizations, which shall represent the interests of discriminated persons. Such Anti Discrimination Organizations must at least provide for 75 members. Furthermore, Germany also has to provide for an Anti Discrimination Authority pursuant to the EU-Regulation. Such Anti Discrimination Authority will be established with the Federal Ministry for Family, Seniors, Women and Youth. The Anti Discrimination Authority shall provide for support of discriminate persons by information, consultation, mediation, evaluation and recommendation with regard to abolishment and prevention of the discrimination and enforcements of the individual rights.

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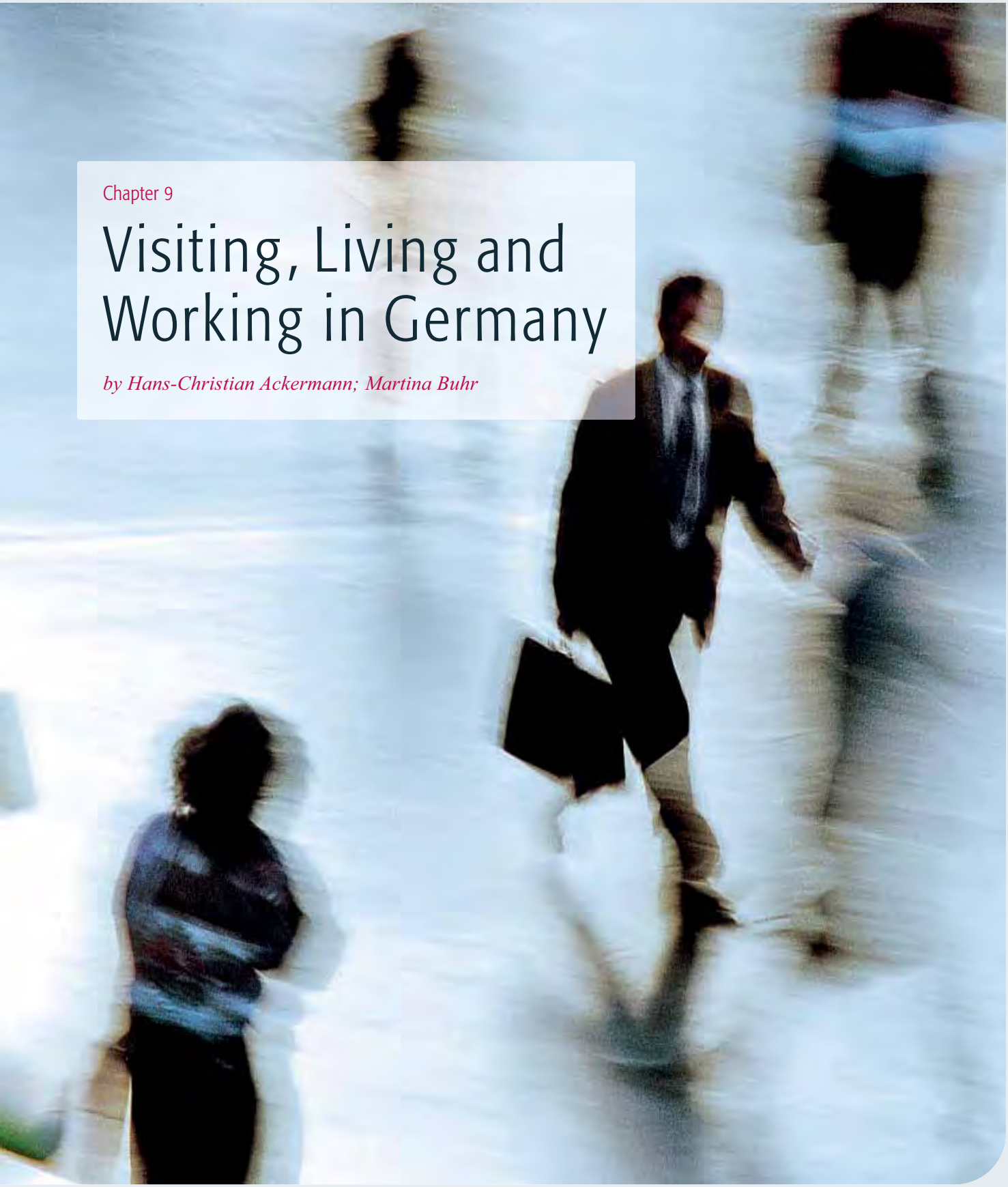

Chapter 9

Visiting, Living and Working in Germany

by Hans-Christian Ackermann; Martina Buhr

A foreign citizen who plans to visit or take up residence and employment in Germany must comply with certain immigration rules and regulations. Such rules and regulations as well as other relevant aspects, such as social security rights and taxation, are discussed in this chapter.

Visitors to Germany

Visa Requirements

All foreigners entering Germany generally require a visa, which grants a limited residence permit. Exempted from the duty to obtain a visa are citizens of certain countries (source: www.auswaertigesamt.de), which include EU Member States and various other countries, such as the USA, Canada and Japan, provided that their stay in Germany does not exceed three months and provided the foreign citizen is in possession of recognized travel documentation. Recognized travel documentation includes a national passport, a child's travel certificate similar to a passport, an official identity card, which permits entrance without a visa based on a bilateral treaty, or other similar travel document. The foreign citizen must furthermore not intend to take up gainful employment in Germany. In this respect, special regulations apply to citizens of EU Member States.

Permitted Activities

Business visitors to Germany may carry out all functions except these defined as gainful employment. Gainful employment under the applicable provisions of the Residence Act includes gainful activities (i.e., work for which remuneration has been agreed upon), work which requires a work permit or work which requires permission to practice a profession.

Functions such as attending meetings, signing contracts, installing, removing and supervising a booth at trade fair or similar services are therefore not considered as employment provided that the visitor is employed by a corporation located in a foreign country and that the visitor's residence remains in said country. Such functions must not, however, continue in Germany for more than three months.

Foreign employees who merely install industrial equipment or machines from foreign companies in Germany or who supervise such installations (or provide advice as consultants) are also not considered to be gainfully employed in Germany.

Application Procedure

Under German law (sec. 71 para. 2 of the Residence Act), the missions of the Federal Republic of Germany, i.e. its embassies and consulates-general, are responsible for issuing visas. In principle, the Federal Foreign Office is not involved in decisions on individual visa applications, nor does it have any knowledge of the status of individual applications being processed by the missions. Visas are issued by the mission responsible for the area where the applicant has his/her ordinary residence or domicile.

Visa application forms can be obtained from the competent mission free of charge (in the local language). The visa application must be submitted together with all necessary documents in person at the German mission responsible for the place of residence of the applicant. In order to avoid time-consuming requests for additional information or documentation, it is recommendable to contact the respective mission in advance of the intended travel to inquire about any special local requirements pertaining to visa formalities.

As a rule, missions require between two and ten working days to decide on an application for a short stay visa. An application for a visa which entitles the holder to a longer stay or to take up gainful employment may take several months to process.

Requirements for the Issue of Short Stay (Schengen) Visas

Under the Convention Applying the Schengen Agreement, these visas also entitle the holder to visits to Austria, Belgium, Denmark, Finland, France, Greece, Iceland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain and Sweden (see Schengen Agreement).

In issuing visitors' visas, missions are bound by the relevant provisions of Community law and German aliens law (the Residence Act and its implementing ordinances). The Residence Act does not grant the right to the entitlement of a visitor's or tourist visa. A visa may be granted provided the applicant's presence does not prejudice or endanger the interests of the Federal Republic of Germany. The applicant must prove that he/she has adequate funds for the intended stay and may not claim any public funds in this connection. Should the applicant be unable to finance the journey and stay from his/her own funds, a host resident in Germany may pledge to cover all costs associated with the trip, including the cost of any medical treatment. Under Sec. 66 et seq. of the Residence Act, such a pledge is normally to be made to the aliens' authority in the host's place of residence in Germany.

Following a European Council decision of December 22, 2003, as of June 1, 2004 visa holders are as a rule required having travel health insurance with a minimum coverage of € 30,000 that is valid for the entire Schengen area. If possible this insurance should be taken out in the applicant's own country, but it can also be purchased by the host. Moreover, missions must be satisfied of the applicant's willingness and ability to return to his/her own country. These difficult and responsible discretionary decisions are always taken in the light of the individual applicant and his/her personal circumstances. The mission bases its decision on its special knowledge of the country and person in question, taking into account also the applicant's own interests, any relevant humanitarian and political concerns and the security interests of Germany and the Schengen partners. Every application must therefore be considered on its individual merits.

If the applicant does not fulfill the above-mentioned criteria, the visa application must be refused. If such consideration reveals the applicant's true purpose in coming to Germany is different from the one stated, the application must likewise be refused.

Pursuant to sec. 77 para. 2 of the Residence Act and to international practice, no reason need to be given for refusing neither a visa application nor any information provided on legal remedies. Pursuant to sec. 83 of the Residence Act, the applicant may not appeal a refusal of his/her application for a tourist visa.

Requirements for the Issue of Visas for Extended Stays

As a rule, all foreigners require visas for stays of more than three months or stays leading to the holder taking up gainful employment. Not subject to this visa requirement are citizens of the EU, the EEC countries and of Australia, Canada, Israel, Japan, New Zealand, the Republic of Korea, Switzerland and the United States of America, who may obtain any residence permit that may be required after entering Germany. Citizens of all other countries who intend to come to Germany for such a stay must apply for visas at the competent mission before arriving in the country. Visa applications must be approved by the relevant aliens' authority in Germany, i.e. the aliens' authority in the place where the applicant intends to take up residence. Visa application forms for a long-term stay (longer than three months) can be obtained from the relevant mission free of charge.

The approval procedure usually takes up to three months, in some cases longer, since the aliens authority will normally consult with other authorities (e.g. the Federal Employment Agency). In cases where visa applications must be approved by the relevant aliens' authority, missions may only issue visas once they have obtained this approval. The aliens' authorities are also the competent authorities with regard to measures and decisions pertaining to residence law for foreigners who already reside in Germany. Aliens authorities are not subordinate agencies of the Federal Foreign Office, and the Federal Foreign Office cannot influence their decisions. They are in fact accountable to and operate under the supervision of the respective interior ministries and senators of the Federal States.

Working in Germany

Access to the German Labor Market

Foreign nationals other than European Union (EU), European Economic Area (EEA) and Swiss nationals may as a rule only reside in Germany for the purpose of taking up gainful employment if they have the requisite residence permit, which allows gainful employment as well. They must not work without it. Australian, Canadian, Israeli, Japanese, South Korean, New Zealand and US citizens may acquire this residence permit from the competent foreigners' authority after their arrival in Germany. They may not however commence gainful employment until they have the permit. Nationals of all other states must apply for a work visa from their local German mission prior to entering Germany.

Access to the labour market for non-EU, non-EEA and non-Swiss nationals is strictly regulated by statutory instrument as a result of the 1973 ban on recruitment and the current high unemployment levels. Access is in principle limited to certain professional groups and requires the prior approval of the employment authorities.

Notwithstanding their countries' accession to the EU on May 1, 2004, nationals of the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia continue to require work permits in Germany because of the transitional rules relating to freedom of movement. They should apply for an EU work permit from their local German employment office.

Social Security

The German social security system generally applies to all employees in Germany on a mandatory basis. However, based on national social security provisions or on an applicable social security treaty concluded between Germany and an individual's home country, it may be possible to obtain an exemption from German social security contributions for a limited period of time.

Secondment

An employee sent to Germany by his foreign employer does generally not fall within the scope of the German social security system provided that the employee remains employed by the foreign employer, the foreign employer continues to pay the employee's salary (and bear it tax wise) during the secondment period and the period of employment in Germany is limited in time. The period of limitation differs depending on the country. A secondment is possible for a maximum period of 12 months with the possibility of an extension up to a maximum period of another 12 months in EU Member States. For countries, which entered into a social security treaty with Germany, the maximum secondment period varies between 12 and 60 months. However, even if there is not such social security treaty secondments up to 60 month have been accepted. In order to prove that the foreign employee is exempted from social security as a result of a secondment, the employee or his or her employer must obtain an exemption certificate (Entsendungsbescheinigung) from the relevant authorities stating that the employee is subject to compulsory social security coverage in the employee's respective country.

Fixed Term Employment

With regard to foreign employees, who were not seconded to Germany but who directly work in Germany within the scope of an existing contractual relationship with an employer in a foreign country, the situation is as follows:

In the case of an EU Member State employee, the employee and his or her foreign employer may apply to the responsible foreign authorities for exemption from German social security. The exemption may be granted if the employee is subject to the social security laws in his or her native country. A release from the German social security system is possible to the extent that the limitation of the employment does not exceed five years (an extension might be possible). The same generally applies to employees who are citizens of a non-EU country, which entered into a social security treaty with Germany (such as Japan and the USA). If such an exemption does not exist, the employee may later claim repayment of pension contributions paid into the German social security system.

For those countries without a social security treaty with Germany, the foreign employee only has the right to claim repayment of pension contributions paid by the time he or she leaves Germany unless they already have sufficient old age expectancies etc. A general exemption from the German social security system is not possible.

Income Tax

General

Individuals who are German residents by virtue of a permanent home or customary place of abode in Germany are subject to German income tax plus solidarity surcharge and possibly church tax on their worldwide income (unlimited tax liability) without reference to nationality. A permanent home will generally exist if an individual has accommodation in Germany at his or her exclusive disposal, this does not require ownership. A customary place of abode is given if an individual is present in Germany for a continuous period exceeding six months, whereby once the six month period has been exceeded, residence is assumed retroactively from the first day of presence in Germany.

If an individual is not a resident of Germany, then only German source income is potentially subject to German taxation (limited tax liability). If an individual qualifies as a tax resident of more than one country, a relevant tax treaty concluded between Germany and the other country of residence may apply to ascertain the country of residence for treaty purposes.

In all cases a tax treaty may apply to restrict Germany's right to tax worldwide income under its national laws. A non-German national who moves his/her home to Germany will usually become liable to unlimited German tax liability – subject to the provisions of an applicable tax treaty.

Taxable Income

There are seven categories of taxable income:

- Income from agriculture and forestry
- Income from trading
- Income form professional and other independent Personal services
- Income from employment
- Income from investment
- Rental and royalty income
- Other income

Taxable income is calculated on a calendar year basis and is gross income less deductions and allowances. Various deductions and allowances are permitted, such as personal allowances, income related expense deductions, special expense deductions and extraordinary allowances.

Under the half-income system, only 50 per cent of dividends distributed to a German individual shareholder by a corporation are subject to individual income tax at the shareholder level. In exchange, expenses incurred in connection with the shareholding are only 50 per cent deductible for individual shareholders. The same applies to taxable capital gains derived from the sale of shares in a corporation.

Tax Rates

For a German tax resident, progressive income tax rates in a range from 15 per cent to 42 per cent apply in 2006 (plus 5.5 per cent solidarity surcharge and possibly church tax on the income tax liability). Church tax amounts to 8 per cent or 9 per cent of the income tax, and is capped at between 3 per cent and 4 per cent of the taxable income, depending on the Federal State of residence of the taxpayer. With effect from the tax year 2007, a so-called tax for rich individuals (Reichensteuer) will be introduced by the increasing maximum income tax rate 3% to 45% for taxable income in excess of KEUR 250 per year (KEUR 500 for married couples filing joint income tax returns), and various deductions and allowances will be reduced or abolished.

Income from Employment

If an individual is a German resident, then all employment income – whether relating to activities carried out in Germany or abroad – is in principle subject to German income taxation. However, if Germany has concluded a tax treaty with the country in which employment activities are physically carried out, then, based on the provisions of that treaty, Germany may exempt the portion of employment income relating to activities carried out abroad from German income taxation. This exemption from German income taxation will usually only apply if certain conditions are fulfilled.

A so-called split-payroll concept is often implemented to take advantage of this German tax exemption. Germany will take any tax-exempt income into account in calculating the applicable German income tax rate.

If an individual is not a German resident for tax purposes, then limited taxation will apply to tax employment income in relation to employment activities carried out or utilized in Germany. Again, a relevant tax treaty may restrict Germany's right to tax this income.

Incentives and fringe benefits received by an employee as a result of employment in Germany are generally taxable in the same way as income from employment and subject to wage taxation at source. This applies in particular to the private use of company car, to which special provisions apply with regard to the calculation of the benefit in kind. Further, stock options granted to an employee in relation to employment activities carried out in Germany during the German residence or possibly after German residence has expired are treated as taxable employment income, however, in most cases the income first becomes taxable on exercise rather than on grant of the options.

Tax Returns

As a general rule, a German resident individual must file an annual income tax return declaring worldwide income. Married couples may file a joint return or opt for separate filing. Income tax returns must be filed by May 31 following the end of the calendar year in question, whereby an automatic filing extension to September 30 applies if the income tax return is prepared by a tax consultant. Additional extensions will usually be granted on application.

Driver's Licence

EU citizens as well as non-EU citizens who do not have a permanent residence in Germany may use their national driver's licence in Germany. EU citizens as well as citizens of countries of the European economic area (EEA = 25 EU member states + 3 EFTA states Iceland, Liechtenstein, Norway) who have a permanent residence in Germany may use their foreign driver's licence until the end of its period of validity. Non-EU or EEA citizens having a permanent residence in Germany may use their national driver's licence within Germany for a period of six months commencing from the date when entering Germany. After six months, every driver who has not obtained a German driver's licence will be deemed to be driving without a licence. Every foreign driver, who suspects that he or she will remain in Germany for more than six months, should therefore apply in time to get his or her foreign or international driver's licence recognized and transferred.

Application Procedure

The holder of a foreign or international driver's licence must generally first obtain an official translation and classification of the licence. This usually results in costs of between € 30.00 and € 80.00. This may be done at the German Automobile Association known as the ADAC (Allgemeiner Deutscher Automobil-Club), the German equivalent of the AAA in the USA. If the foreign driver still has not transferred the licence after three years residence in Germany, not only will he or she be considered to be driving without a licence, but he or she will also have to undergo the usual written and practical examinations in order to obtain a German driver's licence.

Transfer and Recognition of Foreign Driver's Licences

German law regarding recognition of foreign licences is complicated and depends principally on the origin of the driver's licence. A number of countries (e.g. EU member states, Canada, Japan and various States of the USA) enjoy reciprocity, with the result that holders of driver's licences from said countries are not subject to written and/or practical examinations in order to transfer the licence. Exact details and an updated list of countries, which enjoy reciprocity with regard to German driver's licences, can be obtained from the local Driver's Licence Office (Führerscheinstelle) or from the missions of the Federal Republic of Germany. Even if a particular country enjoys full or partial reciprocity and exemption from written or practical examinations, a fee of approximately € 40.00 must still be paid in order to transcribe the driver's original licence into a German driver's licence.

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Chapter 10

Litigation, Arbitration and Mediation

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Litigation

The Court System

Courts in Germany are divided into "ordinary courts" (ordentliche Gerichtsbarkeit) and special courts (Fachgerichte). Ordinary courts exercise jurisdiction over all matters not allocated to the special courts (administrative, tax, labour or social courts), i.e. civil and criminal law. The different branches have been established to guarantee a versed judgment even if very specific matters of law are involved. In total, the court system guarantees comprehensive legal recourse for a party feeling violated in its rights.

Not being part of these regular branches, the Federal Constitutional Court (Bundesverfassungsgericht) is competent for constitutional issues. Besides deciding constitutional disputes, the court reviews laws and cases submitted to it by the regular courts, local or federal parliaments and even individuals. Any person feeling injured by a legal measure which can not (or no further) be reviewed by the regular courts can file a constitutional complaint with the court for the review of the measure.

Civil Jurisdiction

The branch of jurisdiction which might be of most importance for an investor is the civil section of the ordinary courts. Within the ordinary courts, the different hierarchy levels from low to high are: local courts (Amtsgerichte), regional courts (Landgerichte), higher regional courts (Oberlandesgerichte), and the Federal Court of Justice (Bundesgerichtshof).

In local courts, any civil case is tried in front of a sole judge, whereas in regional courts the case shall be tried in front of a chamber of three judges if highly specific branches of law (e.g. communications law, copyright law, etc.) are involved and the case is complex and difficult. However, in practice the sole judge is the standard. Higher regional courts and the Federal Court of Justice always decide as a panel of three respectively five judges. In order to ensure that any case is tried in front of a competent judge, panels specialized in specific areas of law (e.g. anti-trust law, corporate law) have been established by many courts. Although the courts are divided into state courts at the lower levels and federal courts at the top, all courts apply the same law. Unlike in the Unites States, there are no parallel tiers of state and federal courts.

Local courts have jurisdiction over claims worth less than EUR 5,000, whereas claims with a value of more than EUR 5,000 are tried at regional courts. There are some exceptions to that rule (e.g. divorces, family relations) which cannot be discussed extensively within this brief overview. At the request of the claimant, business related disputes under the jurisdiction of regional courts can be delegated to a chamber specialized in commercial matters and consisting of one judge and two expert laymen.

Jurisdiction and Appeal

First instance judgments can be appealed (Berufung) on issues of fact and law if the claim is worth more than EUR 600.00 or if the appeal is explicitly allowed in the judgment. Appeals are brought before the next higher court in the hierarchy. Judgments of the appellate court can be appealed for a second time at the Federal Court of Justice. Such an appeal (Revision) is only permissible if it is granted in the contested judgment and based on alleged errors of law.

Civil Procedure

The German Constitution (Grundgesetz) guarantees all natural and juridical persons the right of due process. Due process includes, inter alia, the right to be present at the trial, to a fair and public trial, to be heard in court and to unprejudiced and neutral judges.

The basic rule of German civil procedural law is the principle of party disposition. Whether a lawsuit is raised, and which type, is at the disposition of the claimant. The claimant may withdraw his complaint entirely, the parties can settle the claim or the defendant acknowledge the claim partially or entirely. A further consequence of the principle of disposition is that the parties are responsible for stating full particulars of claim and defense and to supply their cause with sufficient evidence. In order to do so, the parties can not rely on a discovery procedure, which is unknown to German procedural law. If the defendant fails to defend itself against the claim or to appear at the oral hearing, the court can render a default judgment. If a lawsuit becomes obsolete after it has been initiated, e.g. due to the defendant fulfilling its obligation, the claimant can make a declaration of obsolescence, and the case will be terminated by an order of the court for the costs.

Summary Proceedings for Order to Pay Debts

Taken into account that many disputes related to duty of payment are quite uncomplicated from a legal point of view, there is a need for an efficient, fast, and convenient procedure to recover overdue outstanding debts. German law does provide such an instrument by allowing creditors to file a motion for a court order to pay. The motion is granted without reviewing the merits of the claim. The plaintiff just has to allege that a certain amount of money is due for payment. If the debtor identified in the court order does not contest the claim within two weeks upon service of the order, the creditor can enforce the order. If the debtor objects, the claimant has to decide whether or not to pursue his interests in a regular civil trial.

Provisional Measures

To secure the legal and factual position of a party before or during a lawsuit, German procedural law offers the possibility to obtain interlocutory injunctions (Einstweilige Verfügungen) or attachment orders (Arrest) against the other party. As a general rule, interlocutory injunctions may not pre-empt a final decision by the courts. Thus, it is only under very exceptional circumstances that an interim payment order would be granted. To secure claims for money, an order of attachment into the assets of the defendant can be obtained. If the provisional measure is later on held by a court to have been unjustified, compensation for damages must be paid.

Independent Proceedings for the Taking of Evidence

Irrespective of whether a claim is already pending, German procedural law gives the possibility of independent proceedings for the taking of evidence (Selbständiges Beweisverfahren). As a prerequisite, it must be feared that evidence will be lost or deteriorate until the court officially decides to take evidence. If no lawsuit is pending, such proceedings are also permissible if the party initiating the proceedings has an interest to have determined the condition of a person or thing, the causes for damages and injury or the necessary efforts to remedy damages. Thus, such proceedings are common in cases concerning construction disputes or damage claims for personal injury, or where goods damaged are perishable. The evidence taken in such proceedings can later be introduced into the lawsuit.

Duration of Proceedings

It is difficult to give an estimate for the duration of civil trials in Germany, as the duration of a trial very much depends on the court with which the case is filed and its caseload. For an average claim filed with a regional court, a civil trial may be finished and a judgment enforced six to eight months after the filing.

Costs of a Lawsuit

The costs of a lawsuit are constituted by the court fees and the extrajudicial costs such as the attorneys' fees, which both have finally to be paid by the party losing the case. The court fees are calculated pursuant to the Court Fees Act (Gerichtskostengesetz, GKG) and depend on the value of the claim/the amount in dispute, which corresponds to a statutory defined base fee. To start the proceedings, the claimant has to pay the court fees in advance.

The attorneys' fees are regulated by the Federal Attorneys Fees Act (Rechtsanwaltsvergütungsgesetz, RVG). While fee arrangements between attorney and client are increasingly concluded, in litigation matters it is not permitted to agree on fees lower than those statutory prescribed. Those fees are calculated pursuant to the value in dispute and finally depend on the status of the proceedings: raising the lawsuit, arguing the case during the oral hearing and settling the case each incurs a statutory defined base fee. Although it is possible to agree on higher fees or hourly rates, German law prohibits contingency fees. Furthermore, a party winning the case will only reimbursed with the statutory attorneys fees, even if it has agreed on higher rates.

Arbitration

Differences Compared to Proceedings at Court

For numerous reasons, arbitration proceedings often fit the parties' interests better than a civil lawsuit, especially in disputes arising out of business relationships. In contrast to court proceedings, an arbitration is of private nature and confidential. There is no appeal against the award (except on certain points of law, see infra), which usually effects a faster solution to the parties dispute. Within the strict limits of certain mandatory rules, the procedure is widely at the parties' disposition and can be crafted according to their needs. The parties can select their own arbitrators and appoint expert laymen to the tribunal, which can further the effective and fast resolution of the dispute.

Legal Framework

The German law on arbitration is to be found in the tenth section of the German Code of Civil Procedure (Zivilprozessordnung, ZPO). After having been thoroughly modernized in 1998, the current law on arbitration is based on the UNCITRAL Model Law on International Commercial Arbitration and among the most modern in the world. Any claim with a monetary value can be submitted to arbitration, and no difference is made between national and international arbitration. Arbitration tribunals have the competence to issue temporary injunctions, although these need to be declared enforceable by the competent courts. The competence for all court measures and actions relating to an arbitral award is vested with the higher regional courts. German law does not offer the possibility of an appeal against an arbitral award. In accordance with international standards, however, it is possible to have the award reviewed for certain procedural errors or the violation of mandatory norms of German law. For the enforcement of foreign arbitral awards, the law refers to the New York Convention on the Recognition and Enforcement of Arbitral Awards of 1958.

Institutional Arbitration

Germany has two major arbitral institutions offering full services. The German Institution for Arbitration (Deutsche Institution für Schiedsgerichtsbarkeit, DIS) is a registered association, with approx. 550 members from Germany and abroad, with the aim of promoting national and international arbitration. The DIS offers an administrated arbitral procedure under the DIS Rules, currently from 1998. The German Maritime Arbitration Association (GMAA) is active in the field of international maritime and transport law. It does not offer an administered procedure, but has specialized rules of arbitration and a list of expert arbitrators.

Mediation

Whereas a judgment or an arbitral award is a legal solution imposed by a judge or arbitrator, mediation tries to assist the parties to find their own consensual dissolution of a conflict. Mediation can offer certain advantages in contrast to a lawsuit, especially where long-standing business relationships are affected. As mediation is no legal proceeding in the strict sense, the parties are free to enter the mediation process at any time. To date, mediation has not gained a relevant status as a means to settle business disputes.

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Chapter 11

Regulatory Matters

by Dr. Michael Fritzsche; Dr. Bernhardine Kleinhenz

Investors seeking to put their money to work in Germany are confronted by a wide array of rules and approval requirements from different areas of public law, particularly provisions relating to trade regulations, planning permission, building regulations, and environmental laws. While the latter (environmental laws) shall be dealt with separately (see chapter "Environmental Law"), the trade regulations and the public law regulations shall be described below:

Trade Regulations

General

The admissibility of a business is governed first and foremost by the provisions of the Trade Code (Gewerbeordnung, GewO) and special legal regulations such as those set forth in the laws pertaining to foreigners, skilled trades and other lines of business. The trade law provisions are designed to ensure quality and thus, in the first instance, to protect consumers. Trade law also serves the purposes of public safety law and thus also protects the general public against potential dangers arising from such businesses. Trade law underlines the principle of freedom of trade, which also includes foreign business people, but only to the extent where exceptions or restrictions are not set forth in the Trade Code. Restrictions on the freedom of trade can be manifested in notification duties and duties to obtain permits.

Notification Duties

Any business is subject to a notification duty under the Trade Code. This duty requires that the commencement of a business (including a branch office or a "permanent establishment"), the relocation of the business, the change of business purpose or extension of its purpose to include additional or other activities, as well as the abandonment of a business be notified to the public authority responsible for the specific location (e.g. the local authority or county). This notification is required to allow the authority to monitor the conduct of the business. Apart from the general notification duty of the Trade Code, other special legal notification duties based on other laws also exist such as, for example, under laws applicable to restaurants, skilled trades, and (fire)arms.

Duties to Obtain Permits

A permit must be obtained for special lines of business such as security firms, real estate agencies, commercial developers, and other businesses requiring special supervision. The permit is granted to the business person and therefore constitutes a personal licence. To the extent a permit is not granted to a person, but for an installation, said permit is referred to as an installation licence. Depending on the purpose of the permit, a number of duties are attached to obtaining a permit for the operation of an installation. A permit must therefore be obtained for the construction and operation of installations whose nature or operation potentially constitutes a serious threat to the environment or endanger, substantially prejudice or cause material nuisance to the general public or a neighbourhood.

Under this provision, for example, a permit is required for the construction and operation of immobile waste disposal facilities for the storage or treatment of waste (for further details see the Federal Emission Control Act and in the Ninth Federal Emission Control Ordinance, as stated below in the chapter "Environmental Law"). As opposed to the notification duty, a business requiring a permit may not be conducted until the permit has first been granted. A permit is furthermore not granted until the public authority has examined the matter. The permit does not, however, release the business from the notification duty under the Trade Code.

A special permit procedure exists where planning permission is mandatory for installations that have a particular impact on surrounding areas, nature and the countryside. Nuclear plants, alterations to constructions on the banks of waterways and lakes, and installations with especially high rates of emissions, such as landfills, may, for example, require planning permission. During the permit procedure, the investor's interests are weighed against the interests of those affected by the project, and these interests are reconciled by issuing collateral provisions and requirements that must be met to obtain approval. During the planning permission procedure, legal relationships are established not only between the investor and the authority, but also with all parties affected by the project.

Other Approval or Notification Requirements

In addition to the personal and installation licences, a number of other notification and approval duties are required by various acts of legislation including the Medical Product Act, the Pharmaceuticals Act, and laws relating to food, drugs and labour regulation.

Planning Law and Building Regulations

General

A building permit is required for the construction, alteration, demolition or change in use of a building, unless its size is smaller than that of a detached family house. The admissibility and thus the approval of a building project is governed by the provisions of planning law and building regulation law. Planning law is codified in the Federal Regional Planning Act (Raumordnungsgesetz, ROG) and the Federal Building Code (Baugesetzbuch, BauGB) and regulates the use of land in one entire area (i.e., it sets out roads and building plots etc.). Planning law therefore determines whether a building project fits into its surroundings. If this prerequisite is met, the project may be approved from a planning law perspective. The permit itself is governed by the provisions of building regulation law. Building regulation law is codified in the state building regulations (Landesbauordnungen) of each German federal state (Länder) and sets forth requirements for both design and construction. A permit is granted if the project is admissible under planning law and is not opposed by any provisions of building regulation law or by any other public law provisions that must be considered by the Building Supervisory Authority.

Planning Law

The authority and responsibility of the federal states to establish regional plans which then may be further detailed by local plans is regulated by the Federal Regional Planning Act. All requirements as to safeguarding of public health, development of infrastructure for traffic and other economic needs, promotion and reinforcement of economic activities, etc. have to be taken into account and integrated to an utmost, but balanced effect. One important objective is also the environmental protection already at the source of planning, not just as regulation and control of current activities. Such horizontal environmental protection is aimed at by the planning laws, i.e. limit the use of natural goods (soil, land, water), safeguard areas for recreation and ecological compensation, prevention and control of dangerous establishments/installations and in particular of pollution (hazardous substances for air, climate, soil, water, noise, waste), and implementing an accident prevention and crisis management system. A process of integrated spatial planning provides the instrument for balancing such conflicting objectives of the effective use of land – and the social and environmental development of the area. Environmental impact assessments safeguard that the effects of certain public and private projects are examined and assessed comprehensively and in due time prior to the administrative decision (approval or disapproval).

The admissibility of building projects under planning law is governed by the Federal Building Code. Different provisions apply depending on whether or not a local zoning plan exists for the property to be built upon. Local zoning plans prepared by each community for the land under its jurisdiction contain requirements for the development of the area concerned. Zoning is generally carried out in two steps. First a land use plan and a preparatory and rough local development plan are drawn up. These are then used to draft the detailed local development plan which sets forth the legally binding detailed planning for the zoning area.

Within the scope of application of the detailed local development plan, only those projects are admissible which do not conflict with the plan's stipulations and for which the development of public services is ensured. The development of public services is ensured when the property is connected to the public road network and the supply of electricity and water and disposal of wastewater is ensured. If no detailed local development plan is available, the admissibility of the building project depends on whether the building is to be constructed inside or outside of a developed area. In undeveloped outlying areas only special projects, for example, agricultural or forestry projects or projects destined to supply the public with electricity and water etc., are allowed, while inside of a developed area most building projects are allowed, but must fit into the surroundings as defined by other buildings.

If no detailed local development plan is available for a property on which a building is to be erected and the project is also not admissible under the general provisions of the Federal Building Act for areas without a detailed local development plan, an investor has the option of drafting itself a new plan for the specific building project in consultation with the municipality by preparing a so-called project-related development plan. The investor then concludes an agreement with the community in which the investor undertakes to implement the project and to carry out and to bear the cost of public services development. Once said agreement has been concluded, the community can initiate the local development planning procedure based upon the investor's application and adopt the project-related development plan in the form of a bylaw. This plan constitutes binding planning law for the specific project and has the same effect as a regular detailed local development plan. The building permit for the specific project can be granted on this basis. An investor does not, however, have a right to extend the project-related development plan for other purposes or to a greater area. The investor and community must much rather mutually contract with regard thereto.

Building Regulations

In that the primary objective of a State's building regulation laws is to prevent hazards, the regulations place special emphasis on the safety of buildings to ensure that the inhabitants or visitors of such buildings do not suffer injury from construction defects. The building regulations also define requirements for social standards and environmental protection. Building regulation law also pursues architectural objectives, for instance by placing a ban on buildings that detract from their surroundings or are an eyesore in and of them. In the event a significant contravention of the Federal Building Code and the building regulations occurs, the building authority can stop the construction, order the demolition of the building or prohibit its use.

According to an approach to reduce the regulatory burden, an amendment to several building regulations (e.g. 1995 in North Rhine-Westphalia) has waived the necessity of prior building permit before starting the construction in certain areas of (well defined) local zoning plans and more simple apartment buildings of restricted volume. In these cases – after having checked all requirements of the applicable building regulations, and after having notified the building authority accordingly, submitting all necessary technical plans etc. – the construction activity may just be started. In such instance, the building authority may request to initiate the normal building permit procedure within one month after notification, obviously only in cases of non-observance of legal requirements or of particular complexity of the project. In all other cases the building authority must restrict its interference to later deviations or conflicts with building regulations.

Provisions in the building regulations stipulate when it is necessary to obtain a building permit and what conditions need to be met in order for the permit to be granted. A further building permit is not necessary if a building permit has already been granted under other provisions. For example, some projects need formal planning permission, such as waste dumps or nuclear plants.

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Chapter 12

Product Liability

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German law provides different legal concepts under which the manufacturer, the seller, the importer, the supplier of components or other persons involved in the supply chain may be liable for their products. These particularly are:

- Secs. 433/ 631 et seq. of the German Civil Code (Bürgerliches Gesetzbuch, BGB)
- Law of torts, Sec. 823 et seq. BGB (so-called Produzentenhaftung)
- Product Liability Act (Produkthaftungsgesetz, ProdHaftG)

Statutory Warranty

Overview

The delivery of a product which is free from defects is part of the seller's obligation of due performance, Sec. 433 BGB. The seller is liable for those defects, the sold product shows at the moment of passing of the risk. In such case, German sales law provides for a system of claims that are contingent of each other, Sec. 437 BGB:

- First of all, the buyer has to give the seller a second opportunity for due performance. The buyer may, therefore, claim, at his option, rectification of the defect or the supply of another product free of defects. So the buyer is not allowed to directly rectify the defects on the seller's costs. All ancillary costs related to the rectification (e.g. costs of transport, dismantling, re-fitting etc.) have to be borne by the seller as well

- Only if the seller does not satisfy the buyer's afore-said claims within a reasonable time-limit set by the buyer, further rights or claims of the buyer arise. In this case the buyer can either withdraw from the contract (Rücktritt) or reduce the purchase price (Minderung);

- Also claims for damages (Schadensersatz) or compensation for useless expenses (Ersatz vergeblicher Aufwendungen) are possible. These claims require, however, not only a defect of the delivered product but also a responsibility of the seller for said defect or for the seller's disability to remedy the deficiencies.

The sold goods are defective in the sense of German sales law if they do not correspond to the conditions agreed upon between the parties in the contract. So the starting point in this regard is not an objective view whether the goods are acceptable according to technical standards, "usual standards" etc. but the (individual) agreement between the parties (Beschaffenheitsvereinbarung). For example, irrespective of technical performance a blue car is defective in case the parties have agreed upon the delivery of a red one. This explains the special emphasis that should be laid on the proper establishment of a detailed description of the sold/ purchased goods and their requisite features, preferably by way of a detailed specification sheet (Lasten-/Pflichtenheft). Only as far as the parties have not agreed upon the conditions of the goods, it is decisive whether they are not suited for the presumed use, or not suited for the usual use and do not possess the quality that is standard for products of the same kind and that the buyer may expect (which is also the fact, if the product diverges from public statements of the seller, the manufacturer or his agents, particularly in sales promotions or in designations about special characteristics of the product, unless the seller did not know and did not need to know these statements).

In addition, a defect of the products exists if an agreed assembly is carried out improperly by the seller or installation instructions are insufficient.

Claims for Damages

The seller is liable for both wilful action and negligence, Sec. 276 BGB, and for the faults of his vicarious agents, Sec. 278 BGB. In case the seller has given guarantees for certain features of the products, the seller is liable regardless of fault.

The amount of compensation is not restricted in any way, e.g. to the defective product itself, but can also be claimed for damages to other goods or rights of the buyer. So the buyer's claim may e.g. contain costs for the purchase of a substitute product, loss of profit or damages the buyer himself has to pay to third parties. Also immaterial damage, e.g. compensation for pain suffered (Schmerzensgeld), can be claimed, Sec. 253 BGB. If the seller is in delay with the remedy of the deficiencies, the buyer can claim damages for the loss he suffers during the delayed performance (Verzugsschaden), Sec. 286 BGB.

Instead of claiming damages the buyer can demand compensation for useless expenses he has incurred relying fairly upon the receipt of the benefit, Sec. 284 BGB.

Exclusion of Claims

Buyer's claims for defects are excluded in case he knows or should have known (i.e. gross negligence) the defects at the time the contract was concluded.

Obligations of the Buyer

In case of sales between merchants, i.e. B2B-contracts (Handelskauf), all warranty claims cease to exist if the buyer does not comply with his duty to examine the products immediately after delivery and, in case of defects, give notice of them without undue delay, Sec. 377 of the German Commercial Code (Handelsgesetzbuch, HGB). This obligation to inspect all incoming products immediately after delivery (even if by random examination) often results in the loss of substantial claims, since the requirements imposed by German courts for inspections that are in compliance with the German Commercial Code are difficult to meet in the reality of modern supplier systems. To avoid such loss it is therefore crucial to install proper quality assurance agreements, delegating the responsibility for such inspections from the buyer to the seller.

Warranty Period

The statutory warranty period for movable products is two years starting with delivery. A five years warranty period applies, however, when the delivered (and defective) goods have been used for a building and caused a defect of said building.

Possibility of Deviating Contractual Regulations

Implied warranties for defects can be excluded (by way of individual agreement) or limited unless the seller has given a guarantee for certain features of the sold products, Sec. 444 BGB. Further restrictions apply to limitations of warranty in general terms and conditions. For example, it is not possible to exclude or limit the liability for gross negligence or for damage to life or health of human beings.

The statutory warranty period can be shortened as well as extended by way of agreement, Sec. 202 BGB; as part of general terms and conditions it can only be shortened to one year minimum warranty period for the sale of new goods.

Special provisions for consumer goods purchase (Verbrauchsgüterkauf)

Special provisions apply to a "consumer goods purchase", i.e. the purchase of a product by a consumer from a merchant for private use, e.g.

- deviations from the statutory warranty provisions to the disadvantage of the buyer cannot be validly agreed in advance, Sec. 475 subsec. 1 BGB;
- if a defect appears within six months from passing of the risk, it is assumed that the product has already been defective at the moment of passing of the risk, Sec. 476 BGB;
- even by individual agreement the warranty period cannot be limited to less than two years for new goods, respectively one year for used goods, Sec. 475 subsec. 2 BGB;
- the seller may take recourse against his supplier for all costs incurred with respect to the fulfilment of the seller's obligations vis-à-vis the consumer under the same legal regime as it is available to the consumer. This may take five years from delivery of the defective product or two years from fulfilling the consumer's claims, whichever is earlier.

Law on Works Contracts

In case the seller has manufactured the products individually for the buyer the agreement between the parties is not a sales but a works contract, for which German law provides special provisions. However, in case the entrepreneur is obliged to manufacture and deliver movable goods, the law on sales agreements is applicable though, Sec. 651 BGB. Therefore, most of the supply agreements in a B2B-relationship are governed by sales law. The differences between the law on sales and the law on works contracts have been levelled in 2002 so that the liability of the supplier in a works contract is very similar to that in a sales contract.

Liability under the Law of Torts

In case a manufacturer brings a defective product into the market, he may not only be liable under contractual liability but also under the statutory law of torts (deliktische Haftung). The statutory liability under the law of torts for defective products, which may apply in addition to contractual obligations between the parties involved, is governed particularly in Sec. 823 subsec. 1 BGB (Produzentenhaftung).

Overview

The product liability under Sec. 823 subsec. 1 BGB requires that the defective product has caused an infringement of so-called "absolute rights", e.g. life, health, property etc. – a mere financial loss without the infringement of said rights is not sufficient.

The product liability is based on the general obligation to avoid hazards to the public (allgemeine Verkehrssicherungspflicht). For manufacturers this means that they have to take all measures that are necessary to prevent that their products may harm the life and health or property of their customers or of third parties. Here, the principle of commensurability applies: the bigger the possible danger is, the higher are the manufacturer's duties to maintain safety.

Manufacturer's Obligations in order to Maintain Safety

German jurisprudence has structured the resulting obligations as follows:

- Construction, sourcing and manufacturing of the products have to comply with state of the art of science and technology. The same applies to the instruction of the user of the products;
- The manufacturer has to organize its business in a way that the afore-said sources of faults are eliminated to the extent possible. If so, he is not liable when a defect arises from a unique fault, e.g. an employee's malpractice or malfunction of a machine (so-called "Ausreißer").
- The manufacturer has to issue proper warnings about possible risks aligned with the product and its use;
- After bringing the product into the market, the manufacturer has to observe whether the product shows risks the manufacturer was not aware of before. This also comprises risks which result from accessories to the product, even in case they have been manufactured by a third party. If the manufacturer becomes aware of such risks, he is obliged to issue warnings or even start a recall-campaign in case the products endanger life and health of human beings.

Persons liable

It has to be taken into regard that the liability under the law of torts may not only apply to the industrial manufacturer but e.g. also to the distributor of products (in respect of specific distributor's duties as the duty of inspection, instruction or advice). An entrepreneur who brings a product into the market under his own brand that has been manufactured by a third party for him may also be liable hereunder (so-called quasi manufacturer). If there is more than one manufacturer in the afore-mentioned sense who has contributed to the damage, they all are liable as joint and several debtors (Gesamtschuldner).

Extent of the Manufacturer's Liability

The manufacturer has to compensate the injured party for all financial losses resulting from the infringement of the "absolute right". This may also comprise loss of profit and compensation for pain and suffering (Schmerzensgeld).

In principle, the buyer's interest in the defective product itself is not covered hereby. The latter is only part of the contractual warranty for defects. This restricts the practical use of this legal concept for the purpose of taking recourse in the supply chain. This situation may, however, be treated differently if the defectiveness of the product is restricted to a single part of it which affects other parts of the entire product (so-called weiterfressender Mangel).

Statute of Limitation

What makes up the special importance of this legal concept is the fact that the statute of limitation is substantially longer than the one under contractual liability. In principle, claims for compensation based on Sec. 823 BGB become time-barred within three years from the end of the year in which the claim came into existence and the claimant became aware of the damage and the person responsible therefor, Secs. 195, 199 subsec. 1 BGB.

Law of Torts

The second subsection of Sec. 823 BGB covers a further area of product liability. Here, the liability is linked to the non-compliance of the manufacturer with the requirements of special protective laws. There exist special regulations e.g. in connection with the production of food, pharmaceuticals (Arzneimittelgesetz, AMG) and many others.

Product Liability Act

Overview

The Product Liability Act (Produkthaftungsgesetz, ProdHG) provides for strict liability, i.e. product liability regardless of the manufacturer's fault for the damages caused by his products. Similar to Sec. 823 subsec. 1 BGB, a liability according to the ProdHG requires that the defective product has caused damage to life, health of human beings or to property other than the hazardous product itself. Damage to other objects is only covered in case they are intended for private use, Sec. 1 ProdHG, and the damage exceeds a deductible of € 500.00, cf. Sec. 11 ProdHG. This is the reason why claims under the ProdHG are of no avail to take recourse for defective products in the supply chain. The liability for personal injuries is limited to a maximum amount of € 85 million, Sec. 10 ProdHG. The liability according to the ProdHG cannot be waived in advance, Sec. 14 ProdHG. Since 2004 the liability under the ProdHG extends also to damages for pain and sufferings.

Products in terms of the ProdHG are all kinds of movable objects, even if they are part of another object. Under the ProdHG a product is considered to be defective in case it does not provide that level of safety that the general public, particularly with regard to the relevant purpose of use, may expect at the time of bringing the product into the market. As consequence of the afore-said, there is no liability according to the ProdHG if formerly unknown risks become known because of new insights after bringing the product into the market: an obligation to observe whether the products show risks the manufacturer was not aware of before, does only result from Sec. 823 subsec. 1 BGB.

Persons Liable

According to Sec. 4 ProdHG the liability according to Sec. 1 ProdHG falls upon

- manufacturer of the end-product;
- suppliers (who manufacture parts for the end-products or raw materials);
- the so called "quasi-manufacturer";
- the importer;
- the distributor (if no other liability can be construed).

If there is more than one person liable according to the afore-said, they all are liable as joint and several debtors (Gesamtschuldner).

Statute of Limitation

Claims for compensation based on the ProdHG become time-barred within three years from the moment when the claimant became aware or could have become aware of the damage, defect and the person responsible for the damage, Sec. 12 ProdHG. Claims based on Sec. 1 ProdHG expire 10 years after the moment of bringing the product into the market at the latest.

Burden of Proof

Product liability claims often are particularly dependent on whether difficult technical issues can be proven in court. German procedural law does not provide for a discovery procedure. The outcome of a law suit, therefore, often depends on the question which of the parties bears the burden of proof. Generally, the claimant has to prove all requirements of its claim, e.g. for contractual warranty as well as for claims under the law of torts or the Product Liability Act, the defectiveness of the product or its inherent hazards at the moment of passing of the risk. As the injured person typically is not able to see behind the curtain of the manufacturing process, the burden of proof is shifted to some extent: in principle, the injured person only has to prove that its damage has been caused by a defect of the product. From then on it is presumed that the manufacturer is responsible because of not complying with the afore-mentioned obligations. Under the law of torts it is, therefore, up to the manufacturer to prove that the suffered loss has other reasons and is not attributable to him. Furthermore, in case of a consumer product purchase it is assumed that the product has already been defective at the moment of passing of the risk if a defect appears within six months from passing of the risk (see above).

Amount of Claims for Damages

Other than e.g. in the United States of America, German law does not provide for punitive damages – only the concrete and proven loss has to be compensated. Even though the amounts of compensation for pain and suffering awarded by German courts have increased during the recent years, they cannot be compared to those awards known from the USA.

Criminal Law Implications

Whether a manufacturer of hazardous products is obliged to recall its products – as opposed to a mere warning of the users – depends on whether the hazardous products only endanger other property or whether they endanger life or health of human beings. If the latter is the case an obligation of the relevant manufacturer or even distributor exists. According to the landmark "Erdal Lederspray" decision of the German Federal High Court (Bundesgerichtshof, BGH) the manufacturer/distributor will not only be liable for payment of damages to injured persons but is also subject to criminal prosecution if he does not comply with this statutory obligation to recall the products. In this case, all board-members of a manufacturing company have been verdicted under criminal law – including imprisonment – for not properly addressing health risks emanating from the company's products when these risks became known after bringing the products into the market.

Product Safety Act

Based on the EU-directive 2001/95/EC, special regulations apply for consumer products and work equipment according to the Product Safety Act (Geräte- und Produktsicherheitsgesetz, GPSG) since 2004. The Product Safety Act confers additional powers on the regulatory authorities such as ordering the recall of unsafe products from the market. Furthermore, it establishes a duty to notify the national authorities when a product carries serious risks to consumers. Besides, it strengthens existing obligations of manufacturers and distributors such as to carry out sample testing of marketed products, maintain a proper screening of customer complaints and recall products to protect consumer health. What is more, it entitles and encourages the relevant national authorities throughout the EU to actively exchange all information obtained from manufacturers with each other and with the public using modern information technology.

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Chapter 13

Privatization

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The empty coffers of the public sector in Germany are increasingly forcing federal, state and local authorities to partly or fully sell their amenities and business operations, finance investment projects using private capital ("public private partnership") or to transfer their functions of state wholly or partially to the private sector under other cooperation models. In terms of investment activities, it is the local municipalities in particular which are facing the challenge of clearing the investment backlog to the tune of several hundred billion euros over the next five years. This is unlikely to be possible without the involvement of the private sector.

The legal framework and general conditions for the involvement of private investors are in place in many areas in Germany. Key markets such as the electricity and gas, telecommunications and water markets have been deregulated. Other traditionally public services, e.g. health services, local public transportation and sewage works, are being sold or run more efficiently with the support of private companies and investors. Public buildings and works, e.g. schools, town halls, correctional facilities, roads, tunnels, etc., are increasingly being renewed, built, financed and operated as long-term public private partnership projects (PPPs) involving the private sector, private expertise and private capital.

This situation offers immense business opportunities for private investors.

The public enterprises up for sale frequently operate inefficiently compared with private sector companies. Yet private investors can unleash considerable profit potential, especially with enterprises whose potential the public sector was unable to realize for legal and/or political reasons, by taking optimization and restructuring measures, improving management structures, tapping new business areas and markets which were off bounds to the public sector under public law and other synergy effects. Public authorities are also often under considerable financial and political (once privatization proceedings have been initiated) pressure to sell.

Foreign investors in particular often overestimate the resistance of the local populace to privatization and underestimate the legal and practical means of reducing personnel expenses. Performance-based compensation, the conclusion of collective wage agreements applicable only to the company in question, reasonable periods during which notice of termination may not be given and withdrawal from the public collective bargaining system ("BAT") are legally possible and increasingly (politically) acceptable, a situation which employees are having to accept more and more. Numerous privatizations in Germany have been a great success for both the public sector and the private investor. The „wave of privatization" and „privatization friendliness" is set to grow in many areas in the future.

The Term "Privatization" and Forms of Privatization

The term "Privatization" is not used uniformly, nor is it defined by law. A distinction can be made between the following privatization forms:

Formal Privatization

The reorganization of a public service or a public organization or legal form (e.g. public-law institution (Anstalt des öffentlichen Rechts), municipal enterprise operated by an administrative agency (Regiebetrieb), owner-operated municipal enterprise (Eigenbetrieb), etc.) into a company with a private legal form (e.g. Gesellschaft mit beschränkter Haftung (limited liability company), Aktiengesellschaft (stock corporation), etc. is known as formal privatization.

Example:
Reorganization of Deutsche Bundesbahn (federal railways), a special asset of the federal government, into Deutsche Bahn Aktiengesellschaft (a stock corporation)

Following formal privatization, the public authority remains the sole owner/shareholder of the company reorganized into a private legal form.

The most important reasons for formal privatization are:

- The expectation that the enterprise can be run more efficiently in a private legal form, e.g. as a result of the decrease in political influence;
- The creation of the possibility of (subsequent) investment in the company by private investors, as public-law organizations and legal forms do not permit investment.

Regular Privatization

The partial or full sale of a public enterprise by way of an asset deal or the (partial) privatization of a private company wholly owned by a public authority in an asset or share deal will be referred to as regular privatization or, simply, privatization.

Example:
Sale of 49.9 per cent of the shares in Stadtwerke Bielefeld GmbH to a private energy company by the City of Bielefeld

Contracting Out

Contracting out means subcontracting functions of state while retaining the responsibility for such services.

Example:
Transfer of the function of state of sewage disposal to Stadtentwässerung Dresden GmbH by the City of Dresden that remains responsible for performance of the service

Contracting out and regular privatization can be conducted simultaneously.

Example:
49.9 per cent investment by a private strategic partner in Stadtentwässerung Dresden GmbH

Public Private Partnership

The term “public private partnership” (“PPP”) is also not used uniformly, nor is it defined by law.

A PPP can be defined as a special form of privatization whose aim is to share the risks and rewards of a project between the public sector and the private investor. The public authority no longer uses public assets to provide essential services; these are instead provided by private companies on a partnership basis. Following the principle, “less government, more private enterprise,” the efficiency and customer/citizen friendliness of the service can be increased and the burden on the public budget reduced.

Example:
Renovation, financing and long-term operation of the administrative building of the District of Unna by a project company (GmbH) held by a private construction company (90 per cent) and the District of Unna (10 per cent).

Market Assessment

The key public companies undergoing privatization include in particular:

Public Utilities

Up until the end of the 1990s, there was a true wave of privatization among public utilities. A whole host of German and foreign investors clamored to invest in public utilities, which generally provided electricity, gas, district heating (sometimes including electricity generation) and in some cases water.

It remains commonplace for private investors to hold minority interests (up to 49.9 per cent of shares), although the legal arrangements in the investment agreements generally treat the private investor as if it held 50 per cent of the shares. In many cases, the public seller was also granted a put option enabling it to sell further shares within a specific period at a price calculated in accordance with an agreed formula. Only a few individual investments in public utilities have been up for sale in Germany in the past one or two years. The market is largely consolidated.

Local Public Transportation

The German local public transportation market is currently opening up as a result of public transportation companies being privatized rather than local public transportation services being put out for tender. Both public and private transportation service providers from Germany and abroad are standing in the starting blocks. For the owner, strategic partnerships of this kind offer a way of mitigating the increasing market risks. For the organization responsible for the service, the separation of supply and demand creates an organizational structure in line with competition law, enabling transportation services to be put out to tender in the future without discrimination and without conflicts of interest under EU law.

However, local municipalities can still preserve much of their influence by retaining the majority of voting and/or veto rights. Their objective is to fix the municipal subsidies payable in long-term agreements and thereby limit the financial risks. This requires negotiation of an employment package that includes employees' acquired rights in order to make the sale of shares possible in the first place.

For international investors in particular, municipal transportation companies make interesting acquisition targets due to their long-term operating licences. Further municipalities are expected to decide on a sale, and the consolidation process in Germany will accelerate. Experts estimate that between five and ten large operator companies will remain in the medium term.

Hospitals

The German hospital market has been undergoing fundamental change for some two years. The introduction of flat fees per case (DRG, Diagnosis Related Groups), budget capping and the limitation of funds from the states in particular lead to incalculable financial risks for municipal hospital operators. Moreover, after an action brought by a private hospital operator, the European Court of Justice is now having to examine whether the common practice among public hospitals of having their accumulated operating losses funded by tax revenues from their supporting public authority represents aid that is not compatible with Art. 86 et seq. of the EU Treaty.

Against this background and to safeguard both the future and competitiveness of their hospitals while avoiding future financing obligations, an increasing number of municipal hospital operators are deciding to sell their hospitals. As a result of this wave of privatization, which is likely to intensify in the future, the hospital market has been trans-formed into a buyer's market in which buyers are increasingly able to influence the terms of the transaction. Thus, for example, investors often want to acquire a majority shareholding in a hospital company or buy the hospital outright to ensure that they can exercise significant influence over the running of the hospital. Following privatization, municipalities only hold a „golden share," i.e. a nominal interest in the hospital company, if at all. This gives them certain rights of codetermination under corporate law.

Large private hospital operators with activities nationwide or medium-sized private hospital operators with regional activities have been the main parties interested to date in the privatization of German hospitals. Surprisingly, foreign investors have yet to invest in German hospitals. One alternative to the full or partial sale of a hospital to a private operator is to establish a municipal hospital group. In this case, several municipalities and sometimes also a private hospital operator invest in a holding company that is the sole shareholder of several hospital companies and provides central services for these companies.

Another way out of the financial crisis plaguing hospitals in Germany comes from the United Kingdom in the form a PPP model to secure the long-term viability. The UK hospitals in Hull and Gloucester are just two examples. The renovation or reconstruction of these hospitals was planned, financed and conducted by a private firm and implemented via an operator company. The objectives of improved patient care, lessening the taxpayer's burden and transferring certain risks to the private sector were achieved under this PPP model. The project structure of a PPP model of this kind relieves the burden on public hospital operators and yet secures healthcare as the overriding objective in the long term. "One-stop" healthcare continues to be provided to patients.

Hospital privatization in whatever form offers the opportunity to pool expertise and exploit synergies, thus considerably improving efficiency in the hospital sector.

Example:
Sale of 95 per cent of the shares in Universitätsklinikum Giessen und Marburg GmbH to a private hospital operator by the State of Hesse.

Sewage Disposal

Current ecological, economic and political conditions call for a strategic realignment of municipal sewage companies. In particular, the public sector is struggling with the high backlog of investments required in the sewerage system and sewage works. The private sector has made few inroads into the sewage disposal market in Germany to date. The first significant privatizations in the area of sewage disposal, e.g. Berliner Wasserbetriebe, Abwasserversorgungsbetriebe in Bremerhaven or Hansewasser, have only recently gone ahead. The reason why public sewage disposal companies have jumped on the privatization bandwagon relatively late in comparison to other utilities and why privatization is only now starting to take off is this area's special links to the public sector. In Germany, sewage disposal is defined by law as a „function of state" incumbent on municipalities. This means that municipalities are unable to fully shed sewage disposal services, unlike energy supply, for example. Although this does not prevent the privatization of municipal sewage disposal facilities, it must be taken into consideration in the legal structure of a privatization of this kind. In this case, contracting out and regular privatization must be combined. If it has not already done so, the municipality whose sewage disposal is carried out by an owner-operated municipal enterprise or a municipal enterprise operated by an administrative agency, founds a private-law company, e.g. a limited liability company (GmbH). Protected by an agreement with the municipality, this private-law company then provides sewage disposal services for the municipality, while the municipality retains responsibility for this function of state.

A private investor can then take a stake in the private-law company. This "gradual" privatization requires the various interests of all parties involved to be covered by a complex agreement characterized by a combination of an asset deal (transfer of the assets required to conduct sewage disposal services to the private-law company and sometimes provision of the necessary specialist personnel from the owner-operated municipal enterprise to the private-law company) and a share deal (sale of an interest in the private-law company to a private investor as a strategic partner of the municipality) as well compliance with the regulations governing the charges for such services. In Germany, sewage disposal by multi-utility groups is still in its infancy. It is water supply rather than sewage disposal that is currently the focus of attention. Global groups operating in the area of sewage disposal, especially from France, are attempting to gain a further foothold in Germany. The German sewage disposal market remains to be carved up and thus offers numerous opportunities to private investors to get their share of the cake.

Example:
Transfer of the function of state of sewage disposal to Stadtentwässerung Dresden GmbH by the City of Dresden, which remains responsible for the provision of these services, followed by a 49.9 per cent investment by a private strategic partner in Stadtentwässerung Dresden GmbH.

PPP Projects

In contrast to the United States and the United Kingdom, where PPP (or PFI „public private finance") projects have been highly successful for many years, the first genuine PPP projects were only launched in Germany at the beginning of the new millennium. The pioneer projects focused on investments in roads, such as the Warnow tunnel in Rostock-Warnemünde, which was opened in 2003 as Germany's first privately financed road construction project. PPP models are now primarily being realized in building construction. Projects range from schools and office buildings, to correctional facilities that are in urgent need of investment given the constraints faced by the public budget. Since these are frequently high-volume investment projects, the services to be provided are generally put out to tender across Europe. Yet it is mainly German companies that have vied to partner with the public sector to date. The German federation supports PPP projects by installing task forces at state government level, e.g. in North Rhine-Westphalia, to oversee the financial support of pilot projects.

Example:
Renovation and operation of Unna district hall

Municipal Housing

Only a comparatively small number of housing companies have been privatized to date. It may be assumed that more large portfolios will be put on the market in the coming years. There has only been little real experience of the privatization of public housing companies since the sale of Deutschbau in 1997. However, a growing interest on the part of German (e.g. Viterra (E.On Group), IVG, etc.) and foreign investors – in particular financial investors – in former welfare housing in Germany has since become evident. A number of investors (investor groups) have now appeared on the market that, up until a few years ago, had not been concerned with the acquisition of housing portfolios.

These investor groups have recognized that considerable value-added potential can be exploited by increasing efficiency. Optimizing maintenance and modernization through economies of scale achieved by consolidating existing portfolios is leading to a significant reduction in costs and an increase in value. Investors are also benefiting from the margin that can be generated through the individual sale of residential units to tenants.

This trend is being driven by the low interest rates which provide an attractive return on capital employed for the acquirer as a result of low borrowing costs with a corresponding debt/equity ratio and also allow tenants to buy their apartments at favorable conditions.

A number of standards for mitigating the social impact have evolved in recent years in connection with the privatization of public housing companies. These standards comprise specific arrangements that must be included in the purchase agreement with the acquirer to cushion the social impact of the change in ownership, e.g. clauses to protect tenants, employees, the housing company as a going concern and the interests of minority shareholders. However, the enforcement of such standards conflicts with the anticipated proceeds from the transaction.

Other Areas

The general budget constraints of the public sector are also forcing federal, state and local authorities to examine all other areas in which services are performed for citizens to determine whether they can be transferred to private-law companies. Even functions of state involving force (e.g. prisons) may be outsourced to private companies.

These other areas cover a wide spectrum of economic activities from cemetery maintenance, waste disposal, housing of the mentally ill, detention of convicted criminals, certification and audit firms, to the privatization of casinos. Without going into the specific features of each area, the following applies:

- The public authority must always ensure that privatization is more economical than the previous form of providing the service. The bidder must be ableto demonstrate that this is the case when preparing its determination of a purchase price for a company or the price of a service to be provided for the public authority at a later date;
- Due to the requirement to identify the most economical form of privatization, a competitive bidding process is almost always carried out. The regulations governing such processes are generally fairly identical;
- The closer the subject of privatization is to the core functions of state, the more likely the investor will find itself subject to the de facto and/or legal control of the public authority, even after the privatization, due to laws, directives, etc. (which are often only enacted in connection with the privatization). Such control may relate to both the supervision of casinos by law and inspections by the health authorities to ensure that patients are properly cared for. If there is any scope for contractual arrangements, public-law agreements may be an appropriate complement to private law agreements. In this manner, the private investor can exercise a certain degree of influence over subsequent actions by the authorities in relation to the investment.

A detailed due diligence review remains the safest way for the investor to gain a clear understanding of the legal, tax and economic conditions of the investment and the associated risks. The investor has a right to insist on adherence to private sector standards even if a business has previously been publicly run.

Regular Privatization (Tender Procedure)

The sale of shares in a company by the public sector is only subject to procurement law if construction, service or supply agreements subject to compulsory tendering are concluded in connection with the sale of the shares.

Regular privatization is subject to the stringent and extremely formal rules of procurement law, which tends to be an overall hindrance to smooth privatization. This opens up a range of opportunities for investors to have the procedure and decision reviewed by the responsible public procurement tribunals or by the courts. However, observance of the provisions of procurement law is not only important for the public sector. Frequently, dealing with this complex area is also relatively difficult for the private bidder. It may therefore be worthwhile for a private investor to consult a recognized expert in procurement law.

Regular Privatization (Discretionary Sale)

If procurement law is not applicable, privatization is carried out by way of a discretionary sale, i.e. the procedure can be organized at the discretion of the public seller. However, budgetary law provisions require that the "best value" (not necessarily the highest purchase price) be attained for the asset sold. Generally a fair and transparent bidding process is conducted by an investment bank. The intention to sell is announced publicly. Interest parties have the opportunity to submit an indicative offer on the basis of an information memorandum. The best (normally some 4 to 6) bidders in this phase are then allowed to conduct a due diligence review and, on the basis of an agreement drafted by the seller, to make a so-called binding offer, which is not actually legally binding. By this time, the number of bidders may have been reduced, and negotiations are held until one or more bidders make a legally binding offer. Often this „final offer" may not be subject to approval by an executive body of the bidder, although it is subject to acceptance on the part of the seller and approval by the seller's supervisory authority.

Privatization Agreements

Privatization is a special form of a company sale, as is reflected in the related agreements. The agreements that are normally negotiated are the following:

Purchase Agreement

An integral component of the purchase agreement are the warranties provided by the municipality. The statutory warranty laws are normally contracted out in their entirety and replaced by a self-contained contractual warranty system. For the municipality, it is important to limit the cases of liability as far as possible and to cap the amount of liability. Ideally, this will be a mere fraction of the purchase price. Quite apart from the purely economic consideration that the municipality has no interest in subsequently „repaying" the purchase price due to warranties, unlimited liability on the part of the municipality is also problematic in terms of public law, since municipalities cannot assume unlimited liability under the municipal charters of the federal states. In order to identify potential liability risks to the municipalities at an early stage and to provide contractual cover for such risks, a detailed due diligence review by experienced lawyers and tax advisors is highly recommended prior to privatization.

Redrafting of the Articles

As part of (partial) privatization of a municipal company, it will also be necessary to redraft the articles, since private partners will also demand that they be granted appropriate shareholder rights.

Numerous federal states require that the municipality has appropriate influence, in particular over the supervisory board or a relevant supervisory body. This influence should also be ensured, for example, by means of appropriate provisions in the articles of incorporation. The influence of the municipality should ordinarily be determined according to the amount of the investment in the capital stock and/or according to the voting rights. The appropriateness is determined according to the purpose and amount of the investment. A controlling influence is not required, such that a minority interest on the part of the public authority is also permitted provided that appropriate influence is otherwise ensured. It is not clearly regulated how the public authority can ensure its influence if a supervisory board or other supervisory body does not exist. In practice, however, this question hardly ever arises because municipalities mostly call for the creation of a supervisory board even if this is not legally required so as to create a means of influence by establishing transactions requiring approval. In the case of a facultative, i.e. voluntarily established supervisory board, it is legally possible if required – at least with a German limited liability company – to individually define the rights of the supervisory board and thus to place considerable restrictions on it.

Syndicate Agreement

In the syndicate agreement, the municipality and the private-sector partner set out in particular the main business objectives and the future strategy of the company through which these objectives are to be attained. At this point, the private-sector partner is called on to put forward ideas and suggestions on how to secure and underpin the long-term success of the company. Since the „best partner" cannot just be identified on the basis of the bid price and strategy also pays a decisive role, this gives the private-sector partner the opportunity to make its mark and set itself apart from the competition. In this context, the private-sector partner may be asked to agree to contractual obligations to invest in specific company projects. However, the municipality must ensure that these obligations are actually enforceable with penalties for failure to comply and are not merely declarations of intent. Special rights for the partners may also be stipulated in the syndicate agreement to supplement the provisions of the company's articles of incorporation, e.g. rights to appoint members to the management or supervisory board or rights to veto key shareholder resolutions. An important aspect, and decisive for the political success of the privatization, is the labor law framework, in particular protection against dismissal, vocational training support and continuing education. It is recommended that the long-term commitment of the private-sector partner to the joint venture be secured by means of suitable provisions, e.g. restriction on sale for a specific period. The private-sector partner may also be interested in acquiring additional shares in the joint venture at a later date, in particular to become the majority shareholder. In this case, the syndicate agreement may provide for a put option, whereby the private-sector partner offers to purchase additional shares from the municipality at a specific purchase price or at a purchase price to be determined on the sale date and which the municipality may accept by an agreed date.

The content of all agreements must be coordinated and take account of the individual features of the specific case as well as do justice to the interests of each partner. The above information can only provide a rough overview of the typical content of agreements without going into detail. The extremely complex contractual framework of any privatization is always unique.

Privatization Expertise

As discussed above, the privatization of public-sector enterprises has become an independent transaction market with relatively rigid ground rules, even though each case is unique.

Foreign investors looking to acquire a formerly publicly run enterprise or to manage a company as a joint venture with public authorities in Germany would be well advised to seek professional expertise for this investment from the outset. Professional expertise means a multidisciplinary team of lawyers, tax advisors and, if required, a corporate finance firm well versed in the rules typical of a competitive bidding process. These advisors should also have the proven competence in the relevant industry sector that is indispensable to the success of the acquisition.

In many cases, the procedural rules are affected by European competition law. The special features of German budgetary law and the political implications of the pro-cedures must also be taken into account in the selection of an advisor. It is therefore advisable to work with law firms in Germany. Personal references are critical in the selection of advisors in order to demonstrate to the public authorities from the outset that they are dealing with proven and reliable contact partners – a success factor not to be underestimated. The authors have reported on just some of their own projects in this chapter. They belong to a group of some 25 lawyers specializing in public-sector transactions in various areas.

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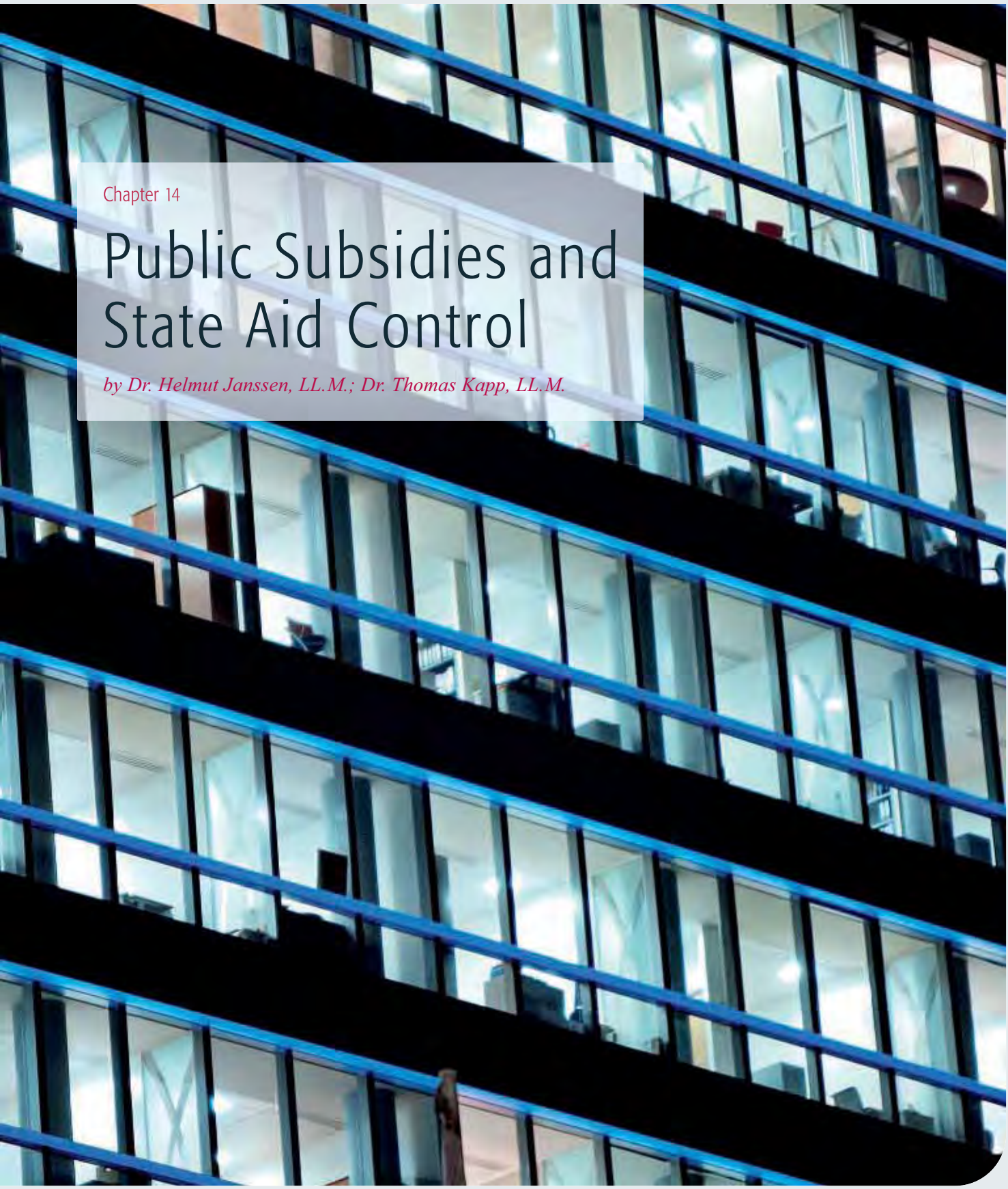

Chapter 14

Public Subsidies and State Aid Control

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

Benefits Available to Investors

Investments in Germany are promoted by many regional, federal and European Union schemes. In 2004 approximately Euro 17 billion were accounted for in German state budgets – for example tax holidays or state guarantees. Other material benefits for investors – for example a municipality transfers a piece of real estate to an investor and agrees a consideration below market value – are not officially accounted for, yet are not uncommon forms of state aid.

In Germany there is neither a central government body responsible for controlling the legality of public grants nor are there coherent rules. Rather, various different legal regimes with different objectives apply. By large one may say that German law sets forth the conditions under which the state may grant subsidies at all, provides for certain rules of procedure and the consequences of a misuse of public grants, while European law establishes a system of control: Those subsidies (and this includes any kinds of benefits!) which have not been approved of by the European Commission are considered illegal and the beneficiary has to return these (including interest) to the member state.

Typical Questions

Apart from the question under which conditions and up to which amount an investor may claim subsidies there are usually two scenarios in which state aid law becomes an issue. First, it has to be questioned whether a recipient of subsidies can be sure that he may keep the aid. This becomes equally relevant when setting up own operations and when investing in an already existing company. When acquiring a company the investor – in the course of its due diligence investigations – has to determine whether or not the target company will be able to retain public moneys it obtained in the past. Second, can a company use state aid law as a weapon against its competitors? For example: Will it be possible to challenge subsidies granted to the beneficiary? Can one avoid that state owned or financed companies enter into competition with private companies? It should also be mentioned that EC state aid rules may also help in tax claims. For example, if a competitor is exempted from a tax burden this might prove to be prohibited state aid which might render illegal not only the legal basis for the exemption but perhaps also of the imposition of that tax.

National Authorities and European Commission

Both national authorities and the European Commission are involved when state aid is to be granted. Furthermore, both sets of rules are to be applied: The European state aid law and the national laws. Under German law the investor usually only has to safeguard that he uses the subsidies in the way as agreed when they were granted to him. Under EU law the investor has to ascertain moreover that the state aid rules are complied with by the member state. Otherwise the investor faces drastic economic consequences: First of all, he has to return any payments or any other benefits received. Contracts that violate the prohibition of state aid are void. Companies may be also confronted with recovery claims after having acquired an undertaking which received unlawful aid. Finally companies may consider to sue for damages or recovery of aid granted to their competitors.

General Rule: State Aid is Prohibited

The EU competition policy aims at promoting the common market and establishing a system of undistorted competition where every undertaking shall be able to operate on an equal basis. The state aid rules intend to avoid discrimination and unfair subsidy races among member states. While the objectives of state aid control are straight forward and simple the detailed rules are not. State aid regulations, block exemptions, guidelines, communications, notices, frameworks etc. cover more than a thousand pages. And the body of case law both by national courts and the European Court of Justice grows day by day.

The fundamental rule is contained in Article 87 (1) EC Treaty: the general prohibition of state aid. The concept of state aid is very broad and applies to measures which satisfy the following criteria:

- There must be an economic advantage that the undertaking concerned would not have had under normal market economy conditions: examples of potential state aid include investment grants, state guarantees, tax relief, loans at reduced rates of interest, the provision of goods and services on preferential terms and capital injections.
- The advantage has to be granted by a member state or through state resources: this comprises advantages which are granted directly by the state and advantages granted by a public or private body designated or established by the state.
- The advantage has to favour certain undertakings or the production of certain goods which means that general measures which apply without distinction to all companies are not regarded as state aid.
- The advantage must distort competition and affect inter-state trade. The Commission takes the view that small amounts of aid, i.e. aid not exceeding a ceiling of 100 000 Euro over any period of three years do not affect trade between member states and do not distort competition (de minimis aid).

Exception: Aid Compatible with the Common Market is Permitted

State intervention is sometimes seen necessary, for example to ensure social and regional cohesion or to improve public services. Therefore, although in principle incompatible with the common market, the EC Treaty contains a list of circumstances in which aid may be granted.

There are three kinds of aid where the Commission has no discretion and must approve the notified aid: This includes aid having a social character, aid granted in the event of natural disasters and aid granted to certain areas of Germany affected by the former division of the country. For other kinds of aid the Commission has broad discretion to assess whether to permit it or not. These include inter alia aid for developing disadvantaged regions, aid promoting research and development and aid promoting culture and heritage conservation.

Existing Aid vs. New Aid

The EC Treaty distinguishes between existing and new aid. For the beneficiary the difference between existing and new aid is crucial: Commission decisions on existing aid can only have effect in the future; thus a beneficiary does not have to return what he received in the past. Rather he has some time to adopt his position to meet the future requirements. A new aid on the other hand which is declared incompatible with the Common market means that the beneficiary´s past position is in danger.

A recent example of an existing aid scheme which has been considered incompatible with the EC state aid rules by the Commission is the preferential tax regime for Luxembourg Holdings. The scheme is granted under a Luxembourg law from 1929. The Commission decided that the preferential tax regime violates state aid rules and required the scheme to be repealed by the end of 2006, while its effects for the existing holdings must be definitively eliminated only by the end of 2010.

In practice, however, the focus is on new aid. For this the EC Treaty provides an ex ante control through a notification procedure. In principle any plans to grant new aid must be notified by the member state to the Commission prior to the implementation. The notification obligation, however, does not apply to aid which falls under one of the block exemptions. To date block exemptions exist for training aid, de-minimis-aid, SME aid and employment aid.
In a first step of this procedure, the Commission will examine whether an aid notified by a member state is compatible with the EC Treaty. Where the Commission does not take a decision within two months after receipt of the notification, the member state as a rule may put into effect the aid.

Where, after the preliminary examination, the Commission finds that the notified measure raises doubts as to its compatibility with the common market, it will initiate formal investigation proceedings. The formal investigation procedure is concluded by issuing either a:

- positive decision, stating that the notified measure does not constitute state aid or is compatible with the common market;
- a conditional decision, i.e. attaching to a positive decision certain conditions;
- or a negative decision, stating that the notified measure is not compatible with the common market.

Prohibition to Implement a Measure

Any new aid which a member state puts into effect before the Commission's approval is unlawful. The Commission may, until it has taken a decision, require the member state provisionally recovers an aid. In the event that the Commission finds that the aid is incompatible with the common market, and if the aid has already been paid the Commission will decide that the member state shall recover the aid from the beneficiary with interest. Interest shall be payable from the date on which the unlawful aid was at the disposal of the beneficiary.

For the beneficiary of state aid it is crucial to ascertain that the aid it received has been properly notified to and approved by the Commission since even the principle of German law, that legitimate expectations are protected, will usually not serve as a means to prevent recovery.

Judicial Review

The prohibition to put aid into effect without the prior approval of the Commission has direct effect, i.e. that undertakings can rely on this provision when contesting e.g. a Commission decision. There are a lot of constellations where beneficiaries of state aid, their competitors or the Commission and the member states may ask for a judicial review of a decision. However, a lot of legal issues are open. Court actions can be pursued in front of the European and the national Courts. Procedures in front of the national courts are especially interesting for competitors since the national courts are responsible for the protection of rights and the enforcement of duties. However, the Commission keeps the exclusive power to decide on the compatibility of aid with the common market.

Protecting the Beneficiary

In general, the beneficiary of an aid can attack a negative decision of the Commission which deprives it of an expected aid. The beneficiary can seek the annulment of the Commission's decision in front of the Court of first instance. In the event that the Commission does not act in the formal investigation proceedings the beneficiary could bring an action for failure to act in front of the European Courts. The beneficiary can also bring an action before a national court against recovery procedures conducted by that member state.

Attacking the Aid

When the Commission issues a positive decision declaring the aid compatible with the common market, competitors could seek the annulment of this decision. However, it should be noted that in order to bring an action for annulment in front of the Court of First Instance just being a competitor is not sufficient. Rather the competitor has to show that it is directly and individually concerned, which can be very difficult to demonstrate. In addition or in the alternative it might be possible to prevent the German administration from granting the aid. However, there is very little case law on this point yet.

If an aid is unlawful but not recovered by the German administration a competitor may seek recourse to the German courts with the aim that they force the administration to recover the aid from the beneficiary. The application of the law is not straightforward in recovery cases. Finally, actions for damages – both against the public authority which has failed to notify the aid to the Commission and the beneficiary – are conceivable, however so far only in theory.

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Chapter 15

Public Procurement

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German public procurement law contains comprehensive regulations governing the legal relationship between public authorities and private entrepreneurs with respect to providing works, goods and services. The intent of public procurement law is to achieve a balance between economically reasonable procurement by public authorities on the one hand and the legal protection of private entrepreneurs on the other.

Introduction

Pursuant to the federal, state and local public budget laws and the German Act Against Restraints of Competition (Gesetz gegen Wettbewerbsbeschränkungen, GWB), all public procurement contracts must generally be put out to tender. The Ordinance on Awards of Public Orders (Vergabeverordnung, VgV) and three other bylaws ("VOB/A" for works, "VOL/A" for deliveries and services and "VOF" for special services like services from architects, auditors or consultants) constitute the legal framework of the award of public contracts in addition to the GWB. Since the federal, state and local budget laws, to the extent they apply to public procurement, are somewhat vague and do not provide legal protection for the tenderer, public procurement law underwent a significant change upon amendment of the GWB in 1998. The legislator thereby incorporated most of the European Directives on the coordination of the procedures for the award of public contracts into the GWB. The incomplete implementation of the European Directives unfortunately makes it necessary to carefully check both the national regulations and the European Directives.

In 2004 the EU procurement regime was updated with two new Directives, one for contracts awarded by public-sector bodies (Directive 2004/18/EC) and another one for contracts awarded by utilities (Directive 2004/17/EC) to replace the current Works, Supply and Services Directive. The directives introduce important new obligations for purchasers, for example on drafting award criteria, disclosing selection criteria and electronic tendering, and explicit rules to areas not currently mentioned in the directives, such as framework agreements and electronic auctions. Also, the directives offer new opportunities for more flexible purchasing including, through the new "competitive dialogue" procedure, dynamic purchasing systems and use of central purchasing bodies. Member states were given till January 31, 2006 to implement the directives.

The national legislator has implemented only a small part of the directives, especially the new award procedure "competitive dialogue" in the so called "ÖPP-Beschleunigungsgesetz" in September 2005. As a consequence according to EU jurisdiction some of the directive rules are direct applicable after exceeding the time limit of implementation.

Thresholds

Chapter IV of the GWB regulates the award of public contracts that exceed certain thresholds as fixed by public ordinances. These are € 5 million for works and € 200,000 for goods and services. A threshold of € 400,000 is set forth in the utilities sector. Contracts on goods and services concluded by the Ministries of the Federal Government are also included within the scope of the GWB to the extent they exceed € 130,000.

Public Contracts

A public contract is defined as a contract for pecuniary interest concluded between a supplier and a contracting authority, the subject matter of which is supplies, works or services. Contracts relating to public works concessions are also governed by the same rules as those contracts for a direct pecuniary interest, while no legislation has yet been passed with regard to service concessions.

Contracting Authority

Contracting authorities set forth in the GWB are:

- The Federal Government, State, regional and local authorities, as well as special funds of each, respectively;
- Other legal entities under public or private law which were established for the specific purpose of meeting the general interest, which do not have an industrial or commercial character, and which are for the most part financed or controlled by public authorities;
- Associations of public authorities governed by public law; and
- Natural or legal entities under private law which operate in the fields of drinking water, energy, transportation or telecommunications if such activities are exercised on the basis of special or exclusive rights granted by a public authority.

General Principles

If a contract is concluded by a contracting authority and if said contract exceeds the applicable threshold, the authority must follow the general principles on award procedures set forth in the GWB. These provide for transparency, economic efficiency, the tenderer's right to compliance with the rules, and equal treatment of all bids submitted. Equal treatment especially requires that local tenderers may not be accorded preference over non-local tenderers (principle of non-discrimination).

One of the most significant general principles concerning the decision on awarding a public contract is the principle that the most economically advantageous bid shall be accepted. This can constitute either the lowest price or, if so published in the prior information notice, various other criteria relevant to the contract such as quality, period for completion or delivery date, other running costs, profitability, after-sale service, technical merit, etc.