

Doing Business in  
*Germany*

2015



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# Doing Business in Germany





Germany's commercial appeal is manifold: it is the world's fourth largest economy and Europe's central economic driver. With an industry focus on engineering especially in automobiles, machinery, metals, pharmaceuticals and chemical goods, Germany has an excellent logistical and technological infrastructure, a highly skilled workforce and a stable economy.

*Doing Business in Germany* is your personal guide to the legal and taxation system in Germany. It covers the main aspects of establishing and operating a company in Germany (focusing particularly on limited liability companies), the labor and tax framework, and the main aspects of German commercial, anti-trust and IP laws. This updated 2015 edition now also includes information on how to get access to capital markets and relevant Banking and Finance laws when doing business in Germany.

Baker & McKenzie has more than 50 years of experience in assisting national and international clients seeking out investment opportunities and doing business in Germany. Throughout this time, Baker & McKenzie has always been particularly committed to understanding and further developing its clients' business goals. The extensive experience and knowledge we have gathered over the years form the basis of this publication.

Should you require any further information about any of the topics covered in this book, or any support in relation to your business in Germany, our team would be delighted to assist you.

Dr. Constanze Ulmer-Eilfort  
Managing Partner, Germany / Austria



# Doing Business in Germany

# Typically German

*The Nibelungenlied, translated as The Song of the Nibelungs, is an epic poem in Middle High German. The story tells of dragon-slayer Siegfried at the court of the Burgundians, how he was murdered, and of his wife Kriemhild's revenge.*

*The Nibelungenlied is based on pre-Christian Germanic heroic motifs (the "Nibelungensaga"), which include oral traditions and reports based on historic events and individuals of the 5th and 6th centuries.\**

\* Texts taken from publicly available sources (Internet etc.)



# 1 GERMANY – AN OVERVIEW

Germany is a highly developed industrial nation and the largest domestic market in Europe, making it one of the most attractive countries worldwide for international investors. The high quality and reliability associated with German products is well known through the famous "Made in Germany" brand.

Key drivers for Germany's success as business location are its excellent infrastructure, relative economic and political stability, an advanced legal system and a highly skilled workforce. These factors provide crucial parts of the security needed for foreign companies and investors in Germany. Moreover, Germany is an important transportation hub opening access to other European countries due to its central geographical location in the enlarged European Union.

According to the United Nations Conference on Trade and Development (UNCTAD), Germany ranks seventh among the world's top ten countries for foreign direct investments with more than EUR 640 billion in inward FDI stocks in 2013.

## Political System

Germany is a federal, parliamentary, representative democratic republic. The German political system operates under a framework laid out in the 1949 constitutional document known as the *Grundgesetz* (Basic Law).

Germany's bicameral legislature consists of the German Parliament (*Bundestag*) and the Federal Council (*Bundesrat*), the representative body of the governments of the states, both based in the capital Berlin. The elected representatives of the Bundestag are organized into parliamentary parties and elect the Federal Chancellor (*Bundeskanzler*) as head of government, who then appoints the federal ministers. Elections take place every four years.

Parties represented in the *Bundestag* are: Bündnis 90 / Die Grünen (The Greens), Christian Democratic Union (CDU), Christian Social Union (CSU), Die Linke (The Left), Free Democratic Party (FDP), and the Social Democratic Party (SPD). The present government is built by a coalition of CDU / CSU and FDP led by Chancellor Angela Merkel. Its term will expire with elections in fall 2017.

The head of state is the President (*Bundespräsident*), currently being Joachim Gauck. The *Bundespräsident* primarily has a representative role. He is elected by the Federal Convention (*Bundesversammlung*), an institution consisting of the members of the *Bundestag* and an equal number of state delegates.

The several states are partly sovereign, with their own legislative and executive bodies responsible for certain areas set out in the federal constitution. Furthermore, the state governments can influence federal policy through the *Bundesrat*.

## **Legal System**

Germany has a civil law system, inspired by Roman law. The law in Germany is codified and – in contrast to common law – not determined by judges. Since legislation is the primary source of law, the legal concept of precedent is unknown. In principle, courts are not bound by previous decisions of higher courts, and judgments have a binding effect only between the parties to the relevant proceedings. In practice however, lower courts and even arbitral tribunals usually apply the case law developed by the higher courts, thereby ensuring that the law is interpreted and applied homogeneously.

## **Economy**

Within Europe, Germany is the largest national economy and ranks fourth worldwide based on the nominal GDP. To the total GDP the service sector contributes approx. 70%, industry approx. 29% and agriculture approx. 1%.

The German industry is traditionally strong in engineering, especially in automobiles, machinery, metals, pharmaceuticals and chemical goods. But German companies also play a leading role in the fields of new technologies such as aerospace, environmental technology, nano technology, medical- and biotechnology. Furthermore, Germany's insurance and re-insurance industry is world-renowned.

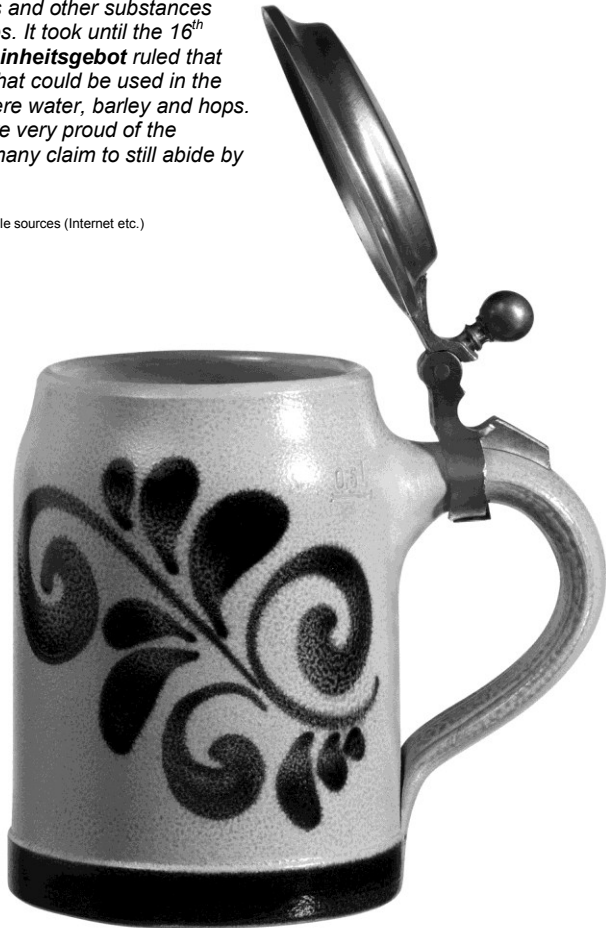
In 2013, 29 of the world's largest stock-market-listed companies measured by revenues (the Fortune Global 500) are headquartered in Germany. Well-known global brands are, for instance, Adidas, Allianz, Audi, Beiersdorf, Bayer, Bosch, BMW, Mercedes-Benz, Porsche, SAP, Siemens and Volkswagen. Alongside international companies, small and medium-sized enterprises (SMEs) are the nucleus of the German economy. More than 60 percent of all employees work in SMEs. The unemployment rate in January 2015 was 4.7%.

# Doing Business in Germany

# Typically German

**Deutsches Bier** (Beer) was brought to the rest of Europe by Germanic and Celtic tribes as far back as 3000 BC, although it was mainly brewed on a domestic scale. Alongside the basic starch source, early European beers would have contained fruits, honey, numerous types of plants, spices and other substances such as narcotic herbs. It took until the 16<sup>th</sup> century, when the **Reinheitsgebot** ruled that the only ingredients that could be used in the production of beer were water, barley and hops. German breweries are very proud of the Reinheitsgebot and many claim to still abide by it.\*

\* Texts taken from publicly available sources (Internet etc.)



## 2 LEGAL FORMS OF DOING BUSINESS

As a foreign investor in Germany, one of the first issues to consider is how to structure your investments or operations from a corporate perspective. German law offers a wide range of options in this respect, including corporate entities with either unlimited or limited liability, hybrid corporate vehicles, and operation through a branch structure. The most common options and structuring models are outlined below.

### 2.1 Limited Liability Incorporated Entities

The most popular forms of incorporated entities are the limited liability company (*Gesellschaft mit beschränkter Haftung, GmbH*) and the stock corporation (*Aktiengesellschaft, AG*). Both are legal entities which provide limited liability for their shareholders. In general, when conducting business through one of these two corporate bodies, only the company's assets are accessible by the creditors of the company to satisfy their claims. In return, the establishment of both entities requires a certain minimum capitalization.

#### 2.1.1 GmbH

The *GmbH* is the most common vehicle through which to conduct business, and it almost suits all kinds and sizes of operation. Its governing regime, the German Limited Liability Company Act (*GmbHG*), does provide the shareholders with broad possibilities as regards the arrangement of the entity's organization. Due to its flexibility, it is widely accepted among small and medium-sized corporations.

The minimum stated capital requirement for a *GmbH* is EUR 25.000. Internal governance takes the form of a two-tier system, consisting of (i) one or more managing director(s) with responsibility for day-to-day management and (ii) the shareholders, which represent the ultimate decision-making body of the company. A *GmbH* can be set up by one or more shareholders.

For further details on the establishment and operation of a *GmbH*, please see Section 3 below.



A sub-type of the *GmbH* is the limited liability entrepreneurial company (*Unternehmergesellschaft/UG (haftungsbeschränkt)*). Such *UG* can be set-up with a minimum stated capital of EUR 1.00. The legal form of a *UG* is primarily used by start-ups and small businesses with no need for substantial capital to start operating their business. In order to expand the equity base, statute requires that in the balance sheet of the *UG* a reserve (*gesetzliche Rücklage*) must be created to which 25% of each year's annual profits (*Jahresüberschuss*) (reduced by loss carried forward from the previous year) shall be contributed. This obligation to retain annual profits remains until the shareholders of the *UG* decide to increase the share capital to EUR 25,000 or above (and thereby convert the entity into a *GmbH*).

### 2.1.2 AG

In contrast to the *GmbH*, the *AG* allows access to capital markets and is therefore the appropriate corporate vehicle where the proposed business requires the issuance of equity or certain debt investments. It is governed by the German Stock Corporation Act (*AktG*). *AGs* can be set up by one or more shareholders, which may be natural persons and/or legal entities. The formation process involves, among others, the notarization of the initial articles of association, the appointment of the first supervisory board members which appoint the first members of the management board, the (partial) contribution of the share capital in cash or in kind, and the registration of the company in the commercial register.

The minimum share capital of an *AG* amounts to EUR 50,000. Beyond the duty to pay in the share capital subscribed for, the shareholders are in principle neither liable for obligations of the *AG* nor required to pay in any additional share capital. German stock corporation law provides for different classes of shares. Typically, German targets have issued bearer shares (*Inhaberaktien*), i.e. there is no share register (*Aktienregister*) kept with the company. Companies with registered shares (*Namensaktien*) must keep a share register. Each transfer of shares needs to be entered into the share register in order to become effective vis-à-vis the company. In case of registered shares, the company may restrict their transferability meaning that the transfer of such shares to a third party is subject to the company's consent. In order to be able to get into contact

with the shareholders, registered shares become increasingly popular. Registered shares also provide better protection against hostile take-overs.

Apart from the difference between bearer and registered shares, a German stock corporation can also have ordinary and preference shares. Preference shares may be issued without voting rights.

The governance of the AG is structured by a mandatory three-tier system, consisting of the management board (*Vorstand*), the supervisory board (*Aufsichtsrat*), and the general meeting (*Hauptversammlung*). The management board is responsible for the management of the company and its representation vis-à-vis third parties. It consists of one or more individuals. In most cases, the management board consists of several individuals, each responsible for certain company resorts and a chairman of the management board (*Vorstandsvorsitzender*). Despite the existence of a chairman all members of the management board have equal legal status. Depending on the number of employees, it may be required to have a director responsible for employment affairs. Unless otherwise provided for in the articles of association, all members of the management board represent the company jointly. The signatory power of the management board is unlimited vis-à-vis third parties.

The supervisory board is, inter alia, responsible for the appointment and removal of the members of the management board, the representation of the AG vis-à-vis the members of the management board and the approval of certain kinds of transactions, as required by law or the articles of association. Also, the supervisory board supervises the management board. However, the supervisory board is not involved in the day-to-day management of the company. Unlike other legal entities or jurisdictions, the powers of the general meeting and of the supervisory board are rather restricted because the management board enjoys a considerable degree of independence. Due to the separation of management and supervision it is not permissible to serve on both boards simultaneously. The supervisory board consists of at least three individuals. Depending on the number of employees, the supervisory board may be subject to German rules on employee co-determination, i.e. it may be required that members of the supervisory board are elected by employees. If the company has on average more than 500 and less than 2,000 employees in Germany (the latter figure is

calculated on a consolidated basis), one third of the supervisory board members must be employee representatives. If the company has on average more than 2,000 employees in Germany, calculated on a consolidated basis, their representatives must make up half of the members of the supervisory board. In the latter case, the chairman of the supervisory board (who is always elected by the shareholders) has a casting vote in case of a tie.

The general meeting appoints and removes the members of the supervisory board (unless they are to be elected by the employees) and is competent for the decision-making of the company with regard to certain basic matters as provided for by law or the articles of association, particularly such matters regarding the constitution and the existence of the company. Even though management decisions, in principle, are made by the management board, according to German case law certain management acts, particularly those acts that trigger structural changes in the company, require the consent of the general meeting with a majority of at least three quarters of the nominal capital represented.

### 2.1.3 Societas Europaea

Besides the aforementioned limited liability entities based on German corporate law, shareholders may also choose to establish a “European” entity, the Societas Europaea (SE). The SE is a legal entity which basically is governed by European community law, complementarily reference is made to national laws. It gives companies with businesses in at least two member states of the European Economic Area the option to merge and operate throughout the European Economic Area on the basis of a single set of rules and a unified management and reporting system. Therefore, setting up an SE can be a convenient way for companies to expand and manage their cross border operations, instead of setting up a network of subsidiaries. Moreover, the SE is perceived as a truly European rather than a national corporation.

Until 2014 approx. 150 operational SEs have been established in Germany, inter alia by such well-known companies as Allianz, BASF, BP Europa, MAN, Porsche and PUMA.

A *SE* can be set up in various ways: (i) by merging two or more existing stock corporations (including already existing *SEs*) from at least two different European Union member states; (ii) by the formation of a holding company through stock corporations and/or limited liability companies, if these entities are from at least two different member states or have had established for at least two years a subsidiary or a branch in a different member state; (iii) by the formation of a subsidiary by at least two companies which operate from at least two different member states or have had established for at least two years a subsidiary or a branch in a different member state; or (iv) by the transformation of a stock corporation which has, for at least two years, had a subsidiary in another member state. Additionally, it can be acquired as shelf company from respective professional providers. A *SE* has a minimum registered share capital of EUR 120,000 which is divided into shares. Each shareholder is liable for no more than the amount subscribed.

The governing regime gives the shareholders several options as regards the organization of the *SE*. For example, the shareholders are free to either go public with the entity or to keep it unlisted. Also, they either may establish a two tier/dualistic system including a supervisory body and a management body, or a monistic system with only one administrative body.

Under the monistic system an administrative body manages the *SE*. This managerial body, directly appointed by the shareholder's meeting, represents the company and may delegate the day-to-day management to one or several of its members.

The dualistic system is very similar to the structure of the German Aktiengesellschaft (*AG*) with a management board responsible for the day to day business of the *SE* and a supervisory board, appointed by the shareholder's meeting, supervising the management board. The members of the management board are appointed and removed by the supervisory board.

On the basis of the European Employee Involvement Directive, the form of employee participation in the *SE* shall be negotiated and agreed upon between employees and management before the creation of the *SE*. If such an

agreement cannot be reached, standard rules which specify a legal standard come into force.

In general, if there are less than 500 employees as at the date of creation of the *SE*, the future *SE* does not need to establish employee co-determination on the level of the supervisory board or administrative body. On the other hand: all aspects of employee participation on the level of the supervisory board or administrative body applied to the company before registration shall continue to apply to the *SE*. Therefore, in general the existing level of participation is preserved in the *SE* equal to the highest level in force in the participating companies before registration of the *SE*.

Besides the European corporate identity, the possibility to preserve the current level of employee co-determination is one of the reasons to choose the legal form of a *SE*.

## 2.2 Unlimited Liability Entities

Traditionally, small and medium-sized German trading companies are often set up as partnerships. Such partnerships are governed by the German Commercial Code (*HGB*).

### 2.2.1 OHG

The basic form of a commercial partnership is the general partnership (*Offene Handelsgesellschaft, OHG*). Although the *OHG* is not a legal entity such as the *GmbH* or the *AG*, it may own partnership assets and may assume liabilities, exercise legal rights, sue and be sued in court. In contrast to the incorporated entities providing limited liability to their shareholders, the partners of an *OHG* are jointly and severally liable for all liabilities incurred by the *OHG*. Such liability of the partners of an *OHG* does not merely exist as an obligation to make additional contributions to the *OHG*, but can be invoked directly by the creditors against the partners. Therefore, the *OHG* primarily is used by a rather small number of partners connected to each other by personal trust. The partners are in general subject to a restraint on competition. Subject to the approval of the other partners, the shares in an *OHG* can be transferred to a third person and/or entity.

The *OHG* is established by an agreement between at least two individuals and/or legal entities to jointly conduct a commercial business (*Handelsgewerbe*). It may be set up by an informal agreement, i.e. a notarization is (contrary to the articles of limited liability incorporated companies) not required. It is not even mandatory to conclude the partnership agreement in writing, although it is highly recommended for documentation purposes.

The *OHG* has to be registered in the commercial register (*Handelsregister*). The application for registration of the *OHG* into the commercial register must contain the names, addresses and dates of birth of all of the partners, the company name of the *OHG*, its domicile and the power of representation of the partners. Also, certain amendments to the partnership agreement, such as changes to the company name, the relocation of the domicile, the change of partners or of their authority to represent the partnership need to be applied for registration in the commercial register. If registration is required, the respective application letter must be signed by all partners.

The internal decision-making process is carried out through partner resolutions. In essence, and in this regard different to corporations, statute stipulates that within partnerships such resolutions shall be taken unanimously by the partners. Nevertheless, the partnership agreement may – within certain limitations – also provide for resolutions to be adopted with a specified majority of the votes.

Each partner is granted individual power of representation by law. However, the partnership agreement may provide for collective representation or a combination of both institutes. Partners may as well be excluded from representing the partnership. In general, the signing authority of partners which are authorized to represent the partnership is unlimited vis-à-vis third parties and may not be limited.

### 2.2.2 KG

Another type of partnership is the limited partnership (*Kommanditgesellschaft, KG*). In essence, the *KG* is a special form of an *OHG*. The major difference is that the *KG* consists of two different types of partners: at least one general partner (*Komplementär*) with unlimited liability and one or more limited partners (*Kommanditisten*), whose liability is limited to their respective capital interest

(*Haftung*). It is constitutive for a *KG* to have at least one general and one limited partner.

The concept of personal and unlimited liability applies in the *KG* only to the general partner or the general partners. They are liable for the liabilities of the *KG* to an unlimited extent. The limited partners are liable only to the amount of their limited partners' capital interest as agreed between the parties and published in the commercial register. The limited partners' capital interest determines the amount up to which a limited partner is liable. It must be registered with the commercial register. Failure to have it registered will result in unlimited liability. The limited partners are exempt from personal liability, if and to the extent they have paid up and made available to the partnership the contribution in cash and/or in kind corresponding to their capital interest (unless and to the extent the contributions have been paid back afterwards)

The limited partners may agree in the partnership agreement, to pay in capital in an amount higher (*Pflichteinlage*) than shown as their capital interest (*Haftung*) in the commercial register. However, regarding the limited partners' liability vis-à-vis creditors of the limited partnership, it is always the amount registered in the commercial register as capital interest that determines the maximum amount for which they can be held liable by third parties.

Unless otherwise provided in the partnership agreement, the limited partner is not obliged to make additional contributions over and above the amount of the capital contribution he or she agreed to pay.

A *KG* is managed and represented by its general partners. In general, limited partners are excluded from managing and representing the *KG*. This distinction results from the statutory regime, which assumes that the unlimited partner is an entrepreneur whereas the limited partner usually takes the role of an investor. However, the latter may be given powers of attorney to manage and represent the *KG*.

The position of the general partner within a *KG* is not limited to individuals. In recent years, it has become very popular to implement a limited liability company as general partner to assume the unlimited liability for the *KG*'s

liabilities (usually a *GmbH* – but even certain foreign limited liability companies may act as such). In that case, however, the creditors of the *KG* may only invoke the general partner's unlimited liability with regard to the assets actually at the disposal of the limited liability company; as mentioned above, the shareholders of the limited liability company generally cannot be held liable for the liabilities of the entity. This is also true for the liability arising from its status as general partner in a *KG*. It is mandatory for such *KG* to operate with a suffix in the company's name illustrating the absence of an individual as general partner (e.g., in case of a *GmbH* as general partner: *GmbH & Co. KG*). This hybrid form of partnership combines tax and structuring advantages of a limited partnership with the limited liability of a *GmbH*. Today, numerous medium-sized companies in Germany are operating as *GmbH & Co. KG*.

### 2.3 Branch

A foreign company can pursue business activities in Germany either through a subsidiary or (directly) through an establishment (*Niederlassung*). Direct business activities of a foreign company with a more than temporary physical presence in Germany constitute by their nature a German establishment of the foreign company.

If the business activities of the foreign company in Germany are of a more than ancillary nature and are pursued through a business organization with a certain degree of organizational independence, the establishment is considered a branch (*Zweigniederlassung*), which has to be registered in the German commercial register (*Handelsregister*). Such branch does not represent a separate legal entity, but merely an establishment of the foreign company in Germany, i.e. the company is liable for the obligations of the branch. The branch comes into existence with the commencement of the respective business activities in Germany.

If the business activities are ancillary only, or are not pursued through a business organization with a certain degree of organizational independence, the establishment is considered a dependent establishment (*unselbständige Niederlassung*). Examples of dependent establishments are information or customer relationship offices (often also referred to as rep offices). Dependent establishments do not have to be registered in the German commercial register.





# Doing Business in Germany

# Typically German

*A garden gnome or lawn gnome is a figurine of a small humanoid creature, usually wearing a pointy hat, produced for the purpose of ornamentation, typically of gardens or on lawns. These figurines originate in 19th century Germany, where they became known as **Gartenzwerg** (literally "garden dwarf").\**

\* Texts taken from publicly available sources (Internet etc.)



### 3 ESTABLISHING AND OPERATING A LIMITED LIABILITY COMPANY (GMBH)

The *GmbH* statute goes back to 1900, having since been modified repeatedly. Despite all modifications, the *GmbH* statute still counts just over 100 sections, quite a number of which can be abrogated by the Articles of Association ("Articles"). Other sections contain mandatory rules governing rights and obligations of shareholders and management.

On November 1, 2008, the most comprehensive reform of *GmbH* law entered into force. The reform-bill, known by its acronym MoMiG (Law for the Modernization of the *GmbH* and to Combat its Abuse), brings about changes to the entire German corporate law. This reform was partly pushed by EU developments. Case law by the European Court of Justice had permitted other European legal entities to set up their registered office and operate in Germany, in this way creating intense competition between the legal forms of operation. Whereas the *GmbH* requires a minimum paid up capital of EUR 25,000, other European entities, such as the British private limited company (UK Limited) and its French counterpart Société à responsabilité limitée (S.à.r.l.) require no paid-up capital and still provide limited liability for shareholders. In particular, the UK Limited became successful with currently up to 40,000 entities operating in Germany. Although the UK Limited does not command respect in terms of financial solidity and despite the fact that UK Limited often go into liquidation as quickly as they are formed, the legislator felt compelled to offer a competitive *one-Euro capital GmbH*.

The legislator used this opportunity to remedy a number of other aspects where case law had become overly protective towards creditors at the expense of shareholders.

German law also offers a number of other forms of doing business, such as sole proprietorships and partnerships. In addition, there are various hybrid forms available, combining partnership structures with corporate elements, such as the limited partnership or the partnership limited by shares. The focus of the

following notes shall be exclusively on the *GmbH* as the most convenient and flexible form of doing business in Germany for foreigners.

### 3.1 Formation of a GmbH

#### 3.1.1 One or more Forming Shareholders

The formation of a *GmbH* requires a resolution to be taken by the founding shareholders (a *GmbH* may also be formed by a single shareholder) in a notarial deed. This notarial deed (*please contact us to receive a sample formation deed including subscription*) will list the founding shareholders, the fact that they resolve on the formation of a *GmbH* with a specific name, city or town of registered office, object clause, and a specific stated capital (minimum EUR 25,000, unless specific statutory rules provide for higher equity in special cases, see below Lit 2.5) as part of its Articles (*please contact us to receive sample articles*). In addition, the managing directors are appointed. It is part of the formation that the shareholders admitted to subscribe for shares in the newly formed *GmbH* enter their subscription either as part of the notarial deed or in a separate notarial undertaking.

Following the formation of the *GmbH* the shareholders will be requested to pay up the agreed equity as provided for in the Articles. In the case of formation of the *GmbH* by several shareholders, the minimum to be paid up is 25% of the stated capital, but no less than EUR 12,500.-. If there is only one forming shareholder, collateral has to be posted with respect to any amounts not paid up. The payment has to be made to an account of the *GmbH* or to an account of the managing director to be denoted as a special capital increase account. Contributions in kind must be made fully available to the *GmbH*.

The notarial formation deed which includes the Articles and the subscription has to be filed with the local register court for recording (*please contact us to receive samples of the formation deed with subscription, the Articles and the register court filing*). This filing is applied for by the managing director(s) in notarially authenticated form. The filing has to contain an affidavit by the managing directors that they have not been sentenced for insolvency violations and that the paid up stated capital is fully available to them.

Following receipt of the filing application with enclosures, the register court will examine the formation deed and the Articles whether they meet the requirements of the *GmbH* law. The register court will record the formation of the *GmbH* in the commercial register (*please contact us for a sample register excerpt*). With the recording in the commercial register, the *GmbH* is incorporated - it has a legal identity of its own -, that is to say it may enter into rights and obligations much like a natural person.

The recording will give public evidence of the name, city or town of registered office, objects of the *GmbH*, the names of its managing directors, whether single or dual signatures are required and details about other signatories ("*Prokurist*") and their single or dual signature powers.

Between the time when the *GmbH* is formed by notarial deed and when it is incorporated through recording in the commercial register, it does not yet have a legal identity. All rights acquired and all obligations entered into by the managing directors during this interim period attach to the managing directors personally. It is primarily for this reason that the period between formation and incorporation should be kept as short as possible and that the management should not enter into obligations or liabilities prior to incorporation. Another important reason is that any depletion of the paid-up capital prior to incorporation gives rise to a personal liability for the forming shareholders to make up such deficiency existing at the time of incorporation.

Once the *GmbH* has become incorporated, any rights and obligations created between formation and incorporation attach to the *GmbH* by operation of law as the new legal entity.

The time between filing the complete formation documentation with the register court and the recording of the *GmbH* - thus its incorporation - takes approx. 1 – 6 weeks, depending on the workload at the respective register court. In urgent cases, recordings have been achieved within a few days from filing, but this high-speed recording cannot be guaranteed. Formation costs for a minimum capital company are in the range of EUR 250 for notarial fees, EUR 400 for court fees and EUR 800 for attorney fees, all in the case of an uncomplicated wholly owned subsidiary formation.

### 3.1.2 One - Euro Capital Formation

One of the most groundbreaking issues of the new law is the introduction of a new sub-type of a limited liability company which can be formed without minimum capital, the only requirement being that there is a capital of at least one Euro .

This *one - Euro company* may not call itself "*GmbH*", but has to call itself as "*Unternehmergesellschaft*", (meaning "Entrepreneur Company") or abbreviated "*UG*", always with the additional specification "limited liability".

This Entrepreneur Company provides full limited liability for its shareholders. To this extent, it is comparable to the UK Limited or the French S.à.r.l.

The novelty regarding this new Entrepreneur Company is not only its formation with a capital of at least one EUR, but also the fact that 25% of its (after tax) profit for the year have to be retained and credited to a mandatory reserve account until such time when the reserve account shows an amount of EUR 25,000. This reserve account must not be distributed, but may only be used to balance a loss for the year or losses carried forward – and, of course, for its conversion to issued share capital once the EUR 25,000 have been reached. Once the Entrepreneur Company increases its issued share capital to EUR 25,000 – whether by use of the mandatory reserve account or by contribution of fresh cash or assets -, it may call itself "*GmbH*" and the reserve account is no longer mandatory.

As long as the company is an Entrepreneur Company, its directors are subject to a strict obligation to call a shareholders meeting in case of an imminent inability of the Entrepreneur Company to pay its debts.

### 3.1.3 Name of the GmbH

The choice of name is free, as long as it does not mislead the public. This also implies that it must be sufficiently distinguishable from other names used in the market place.

It is always advisable to clear the desired name with the local Chamber of Industry and Commerce prior to formation. The Chamber will research whether or not similar names are already in use in the local business community and whether or not the name is misleading in other ways (a misleading name could be "European Lorry Transports *GmbH*", when the *GmbH* has little capital and operates on a local or regional basis only).

Additional certainty as regards the name should be obtained by running a service- or trademark search in the product or service classes relevant to the activities or products of the *GmbH*. Frequently, a desired name meets with no problems on a local level, but is confusingly similar to a protected trademark. In this situation, the newly formed *GmbH* could, whenever the holder of the protected trade or service mark learns of its existence, be required to change or amend its name. It follows from these considerations that it is generally advisable for a new *GmbH* to seek to register its name as a trade or service mark, although not all names will qualify for registration as a trade or service mark. In the same way, it is recommended to register a service or trademark for the new name in order to protect it against newcomers or copycats.

### 3.1.4 Registered Office

The Articles must state the registered office of the *GmbH*. It is sufficient to state the name of a city or town such as Frankfurt am Main. There is no need for a specific address to be given. Any move of the *GmbH* within city limits does not require an amendment to the Articles, but has to be notified to the local register court. A move to another town or city has to be reflected by a change in the Articles and a change in the commercial register recording.

Pursuant to the old law, the registered office of the *GmbH* had to be at the place where the *GmbH* was operated and this place had to be within Germany. This requirement was removed. While the registered office still needs to be in Germany, the *GmbH* may be operated from outside Germany.

### 3.1.5 Object Clause

The Articles of the *GmbH* must describe its objects in general terms. The description need not be specific, but it should give a fair indication of the



planned scope of activities. The wording of the object clause does not prevent a subsequent change of activities. German law does not operate any ultra vires doctrine. A *GmbH* having as its object the running of a steel foundry may switch to operating a chicken farm, unless a shareholder should object. Nevertheless, any change in activities or products should be reflected by a change in the object clause.

Certain activities require the consent by regulatory authorities, such as banking, insurance, certain pharmaceutical and chemical activities, to name but a few such areas.

Although this is not mandatory, the object clause would normally include wording to the effect that the *GmbH* can operate branch offices and set up subsidiaries.

### 3.1.6 Capitalisation

The *GmbH* law requires a minimum capitalisation of EUR 25,000. There are specific laws, which stipulate higher minimum capitalisation requirements for certain industries or services: e.g. a *GmbH* formed to undertake accounting and auditing activities must have a minimum equity of EUR 50,000.

The capital may be contributed in either of two ways: If the formation or capital increase resolution stipulates a cash contribution, the cash must be paid to the *GmbH* and it must be and remain freely available for bona fide business purposes of the *GmbH*.

If the formation or capital increase resolution should stipulate a contribution in kind, the type of contribution must be specifically described. Furthermore, the commercial register will usually investigate the value of the contribution in kind to determine whether it is equivalent to the cash value ascribed to it in the resolution. This investigation can be assisted by management filing a CPA valuation opinion with the commercial register together with the corporate documentation.

The two types of capital contribution must be clearly distinguished. If shareholders wish to conduct an initial capitalisation or a capital contribution in

kind, this must not be dressed up as a contribution in cash, for example by contributing cash in a first step, which cash is thereafter used to purchase assets from or repay liabilities owed to shareholders. Such two-step transaction would not be recognised by German courts as a valid cash contribution. This has the consequence that the shareholder re-mains fully liable for the cash contribution as agreed in the formation or capital increase resolution irrespective of the fact that the *GmbH* may have obtained good title to the respective asset or relief from a liability, although the proven value of the de facto contribution in kind can be set off against the cash payment obligation still owing. In addition, management has to supply an affidavit when filing the formation or capital increase resolution with the commercial register that the contribution has been duly rendered by the shareholder and received (for good) by the *GmbH*. If this affidavit should be incorrect, there could be criminal liability for the management.

There is joint and several liability for all shareholders of the *GmbH* in the event that the agreed capital contribution cannot be obtained from a specific shareholder. This liability becomes relevant only after attempts to obtain the contribution from the respective shareholder have failed.

The capital, once contributed, becomes subject to strict maintenance rules. *GmbH* statute and case law stipulate that contributed capital may, absent a valid capital decrease, not be paid out to shareholders under any circumstances. This applies not only to outright cash transfers; it equally applies to transactions between the *GmbH* and its shareholders, if they are, to the detriment of the *GmbH*, not based on arm's length considerations. Case law has expanded this concept even to upstream loans whenever these are not covered by capital in excess of the stated capital.

### 3.1.7 Shares

The *GmbH* cannot issue share certificates like a joint stock corporation. The shares in a *GmbH* are exclusively evidenced by notarial deed with the first shares originating from the time of formation of the *GmbH*. Subsequently, shares are created either by capital increases or through assignment of split shares.

The only requirement as regards denomination is that the normal amount of each share should be rounded to one Euro. So there can be one share for EUR 25,000 or 25,000 shares for one Euro each, or any values in between. All shares are numbered. Each shareholder may acquire any number of shares at the time of formation or at the occasion of a capital increase. This greatly facilitates the creation of shares in useful amounts and their assignment. Any transfer of shares requires and will be evidenced through a notarial deed. Absent this notarisation there can be no valid transfer of shares.

There are no statutory rules providing for a shareholder book or other corporate records with respect to the existence of specific shares and their ownership. The Articles may provide that the transfer of shares is only valid subject to the consent of the other shareholders.

German law does not require shareholders to be registered, but allows for bearer shares even in public corporations. In a *GmbH*, share certificates are hardly ever issued (they would not have any substantial function), and there is no share register in the traditional sense either. This made transactions involving shares in a *GmbH* a rather burdensome operation in terms of due diligence.

Similarly, any undertaking to buy or sell shares, any options and similar legal instruments affecting rights in shares is only valid and binding if part of a notarial deed. This requirement also extends to a pledge of shares. Exceptions to the requirements of a notarial transfer deed in the case of share transfers are, amongst others, redemption of shares by shareholder resolution, inheritance, mergers, etc. Trust agreements involving *GmbH* shares are only regarded as valid if the obligation on the trustee to surrender the shares is notarised.

Legally defective share assignments are not always immediately recognised as such. Since there was no good faith acquisition of shares (prior to the 2008 reform), it was essentially necessary to review all share assignments and share divisions and share combinations from the date of formation of the company by way of due diligence exercise in order to achieve certainty regarding the currently contemplated transaction. Although each share transfer had to be notified both to the company and, by way of new list of shareholders, to the

register court, neither information was legally reliable as regards title to the shares.

Under the new rules this shareholders list will increase in importance: Provided a shareholders list has been lodged with the register for three years running without a complaint filed against it and provided the purchaser of shares does not have positive knowledge (or is grossly negligent in this regard) that the list is incorrect, clear title can be acquired from whoever is shown on such list as shareholder. In a situation where a notary notarised a deed transferring shares, it is the duty of the notary to prepare and file the new list of shareholders, comparing same to the list previously on record with the register.

In view of this expanded function of the shareholders' list it will now be easier to obtain certainty as regards good title held by a party wishing to sell shares. Under the old system even a search involving an unbroken chain of notarial deeds dating all the way back to the original formation could not provide full certainty on good title since there may have been a notarial transfer of shares breaking the chain which was not brought to light by the search. In future, the shareholders' list will add certainty for all parties, but it is not foolproof. In view of these problems, considerable reliance will still have to be placed on the respective representations and warranties to be demanded from the seller of *GmbH* shares.

### 3.1.8 Fiscal Year

German accounting law stipulates that the fiscal year of any business entity may not exceed one year. Upon start-up, business entities are entirely free to determine at what time during the calendar year their fiscal year shall commence to close 12 months thereafter. 12 months is the longest period permissible for a fiscal year.

The same applies to the *GmbH*. The forming shareholders may at the time of formation determine the close of the fiscal year of the *GmbH* at any time during the year. The first fiscal year of the *GmbH* will commence at such time, when the *GmbH* starts its operations, earliest at the time of its formation, latest at the time of its incorporation. Normally, there is a stub fiscal year from the time when the first fiscal year commences and when it closes as determined in the Articles

(e.g. *GmbH* commences business on May 11 and the fiscal year is stipulated in the Articles to commence on February 1 of each year and to close on January 31 of the following year - in this case there will be a stub fiscal year from May 11 through January 31 of the following year).

Whereas the initial choice of fiscal year is entirely up to the forming shareholders, any subsequent change of the fiscal year requires the consent of tax authorities, unless the change implies that the new fiscal year will coincide with the calendar year. Tax authorities will normally grant their consent to a change of fiscal year if there are sound commercial reasons, such as the desire to have the fiscal year of the *GmbH* coincide with the fiscal year of its parent company or if a profit and loss pooling arrangement ("*Organschaft*") is to be put in place.

### 3.1.9 Other Rules in Articles

Over and beyond the elements described above, the Articles may, but need not, contain rules on the following aspects (*please contact us to receive sample articles*):

#### 3.1.9.1 Shareholders' Meetings

The Articles may stipulate frequency, place and other details with respect to shareholders' meetings. *GmbH* law requires a minimum one-week calling notice for the conduct of a shareholders' meeting. Frequently, this notice period is considerably lengthened in the Articles. Certain participation stipulations are laid down, for example to determine whether or not shareholders may participate with or without advisors or to whom they may extend a proxy. The Articles may also stipulate specific rules as to the conduct of shareholders meetings. No such rules are needed in case of wholly owned subsidiaries.

#### 3.1.9.2 Standing Orders / Rules of Procedure

Frequently, the Articles will provide Standing Orders for management and / or a Supervisory Board. Alternatively, in order to keep essentially internal matters from public scrutiny, the Standing Orders may be resolved by the shareholders

meeting and, in this way, become just as binding on management and / or a Supervisory Board, although they are not filed with the Register Court.

### 3.1.9.3 Restrictions on Sale and Transfer of Shares

The Articles may provide for restrictions on the sale and transfer of shares. These restrictions are designed to ensure that individual shareholders do not sell and assign their shares to parties whom the other shareholders would prefer not see as shareholders, such as competitors. Such restrictions are generally not appropriate for wholly owned affiliates.

Such restrictions on the sale and transfer of shares make the validity of the transfer or any other share disposition dependent on an approval resolution of the share-holders' meeting. On the other hand, such restrictions must not have the effect of locking in a shareholder who wants to part with his shareholding. Consequently, the restrictions must be accompanied by suitable rules to permit the departure of such shareholder. Such rules could provide for example for redemption of his shares. Alternatively, they could provide for a right of first refusal for the benefit of other shareholders or parties designated by such other shareholders. Or they could provide for any other mechanism, under which the shares are taken over by other parties determined by the shareholders.

Those rules must be carefully drafted to ensure that the departing shareholder obtains a fair consideration for his shares reflecting the value, which he is surrendering.

### 3.1.9.4 Special Rights and Obligations

The shareholders are free to create different classes of shares, giving different voting and / or dividend rights. In fact, the *GmbH* law is so flexible that the dividend rights may be divorced from the shares and be determined, for example, according to the respective profit contribution rendered by each shareholder under a predetermined formula.

The shareholders may also resolve on certain obligations to be performed by specific shareholders. This could cover, for example, the rendering of personal services or the contribution of certain know-how. Similarly, the Articles may

provide that a shareholder rendering personal services must surrender his shares (against consideration) at such time, when he ceases providing his personal services.

The Articles reflect the extremely flexible nature of the *GmbH*. A wholly owned subsidiary needs only short Articles, whereas a *GmbH* with a large number of shareholders will require very detailed Articles.

### 3.1.10 GmbH Stationery

At the time when the *GmbH* commences its operations, it must make certain that its stationery conforms to statutory requirements. This means that the stationery must list the registered office of the *GmbH*, its registration number with the local register court and the names of all managing directors and, to the extent applicable, of the chairman of the Supervisory Board, each with one full Christian name.

## 3.2 Operation of a GmbH

### 3.2.1 Powers of Management

The Powers of Management cannot be limited in the Articles with effect towards third parties. The only limitation, which will have effect towards third parties, is to tie the signature of each managing director to the co-signature of another director (four eyes principle). This limitation can be enforced against third parties, because the single or joint signatory power of a managing director is recorded in the commercial register and is thus deemed to be public knowledge. No other limitations can be recorded in this manner.

However, if managers habitually sign singly and their actions are recognised by the *GmbH* as binding, the *GmbH* will be estopped from raising the dual signature defence in trying to avoid contractual obligations.

This notwithstanding, the shareholders meeting may resolve, for example, on a list of actions and transactions which management may only perform subject to prior consent of the shareholders meeting or any board as provided for in the Articles. Such a list may also be part of the Standing Orders for management.

Any managing director violating these internal rules will be subject to a damages claim raised by the shareholders and, quite likely, a dismissal without notice for cause. However, the *GmbH* may not hold a violation of internal rules against a third party, unless the third party knew about these rules.

Management is responsible for the day-to-day running of the *GmbH*. Management is also responsible for observing all statutory rules and regulations, which apply to the *GmbH* and its business, not least in the area of taxation. In the event that employees in conducting the *GmbH* business should breach the law, the ultimate responsibility (and with it any penalties) will attach to management, unless management can show that it has at all times properly instructed, organised and supervised its personnel.

### 3.2.2 Prokurist

German law provides for a second level executive position called "*Prokurist*". A person is appointed *Prokurist* by the managing directors based on a vote of the shareholders' meeting. The appointment and the signature power (single or joint and whether together with another *Prokurist* or with a managing director) are recorded in the commercial register. Upon appointment, the *Prokurist* has a range of powers as determined by the Commercial Code.

These powers are for all practical purposes equivalent to that of a managing director, but with some limitations: The *Prokurist* may not appoint other *Prokurists*, the *Prokurist* may not sell the business as a whole and the *Prokurist* may not enter into real estate transactions on behalf of the *GmbH*.

As in the case of the managing director, the *Prokurist* may have joint or single signature power. The joint power of a *Prokurist* may be tied to the signature of another *Prokurist* or that of a managing director. Conversely, the joint signatory power of a managing director may, as noted above, be tied to that of another managing director, but also to that of a *Prokurist*. However, in a situation, where there is only one managing director, his signature may not with legal effect towards third parties be tied to that of a *Prokurist*.



The position of *Prokurist* carries considerable prestige in Germany and is often used to reward employees without actually appointing them as managing directors.

### 3.2.3 Shareholders' Meetings

Shareholders' meetings are normally called by management, although they can also be called by shareholders, observing the form and notice period as provided for in the Articles. The form of a proper calling notice is normally in writing, whether by registered mail or not. The notice period is often determined by the shareholders in the Articles to suit their needs.

Normally, the meeting will take place at the registered office of the *GmbH*, but the shareholders may determine another place. The shareholders appoint a chairman of the meeting and a protocol is taken and signed.

Votes are counted in accordance with the rules as stipulated in the Articles, normally by reference to the nominal value of shares held. Alternatively, the Articles may provide for different voting classes of shares. They may also stipulate that votes be allocated to shareholders independently of shares held.

The Articles may provide for a quorum, normally stipulating that in case a quorum is not reached, a second shareholders' meeting shall be called observing the normal notice period and with the same agenda, but which shareholders' meeting shall no longer require a quorum.

In the event that the shareholders' meeting should wish to resolve on a change of the Articles of the *GmbH*, for example increasing or decreasing the stated capital, the respective resolution is only valid if part of a notarial deed and subject to a voting majority of 75%. The deed with the resolution and the amended Articles has to be filed with the commercial register for recording. The change in Articles becomes valid upon its recording in the commercial register.

Irrespective of their shareholding percentage, under the statute shareholders have a wide ranging right to inspect the books and obtain information on the *GmbH* and its affairs. This right may not be abrogated or limited in any way by the Articles or factual circumstances.

### 3.2.4 Thin Capitalisation = Interest Barrier

For tax purposes, net interest payable (to all parties) is only deductible in an amount of up to 30% of taxable EBITDA. There is a safe harbour limit for net interest of up to EUR 3 million which is not applicable once net interest exceeds the limit. The barrier does not apply as between members of an "*Organschaft*". In case the borrower can show that the international group to which it is a member has a debt-equity ratio no better than the one shown in its books, the interest remains deductible, provided no more than 10% of the net interest is payable to affiliates.

The criterion "taxable EBITDA" takes out all exempt dividends and corresponding capital gains from shares, just as it does treaty exempt income from permanent establishments. Any interest not deductible is carried forward. The creditor has to declare the interest received as taxable income even if the interest is not deductible for the borrower.

### 3.2.5 Capital Increase / Capital Reduction

*GmbH* law provides that all shareholders have the right to participate pro rata in any capital increase. Similarly, in case of a capital reduction, all shareholders suffer an equal reduction in the nominal value of their shares.

Once a *GmbH* requires the infusion of additional funds in order to finance business expansion or in order to balance losses, shareholders have various options for contributing such funds: They may increase the capital through contribution of fresh cash or simply contribute new cash by way of loan or paid up surplus.

A frequent legal trap for shareholders wishing to increase the capital of their *GmbH* is the following: The shareholders agree on a capital increase against contribution of cash. The cash is paid up, but the *GmbH* subsequently uses the cash in order to purchase assets from a shareholder or an affiliate. In this situation, case law holds that the asset purchased is the real contribution. For this reason, the capital increase should have been resolved by way of contribution in kind, facilitating a valuation of the asset in order to protect the market against overvaluation of assets contributed. The consequence of such

"covert contribution in kind" is the review of the value of the asset transferred. In the event there should be a shortfall in value when compared to the cash contribution originally agreed, the shareholder remains liable to pay up the balance. For example, in case the *GmbH* should subsequently go into insolvency, the trustee in insolvency is able to require the cash contribution in the amount of the open balance.

The contribution of intercompany loans to capital in a crisis situation is nearly always impossible, since this requires the submission of a CPA opinion confirming that the intercompany receivable to be contributed to the *GmbH* has the market value attributed to it in the capital increase resolution. Such opinion cannot normally be issued where the intercompany receivable arose from financing the operating loss of the *GmbH*. The market value of such intercompany receivable is no higher than the price, which an independent third party would pay for the assignment of the intercompany receivable. If the intercompany receivable has no more than a notional value, it cannot be used as a contribution in kind, although a subordination of the intercompany receivable may assist in improving the balance sheet of the *GmbH*. A waiver is not normally recommended since for tax purposes the balance between the nominal value and the lesser fair market value is recognised as a taxable profit.

Shareholders must similarly be cautioned against any attempts to convert intercompany receivables of doubtful value into capital by a more circuitous route. It could be considered, for example, to contribute cash and, following recording of the capital increase, to use the cash to repay the intercompany receivable and thus achieve an effective conversion. If the intent or effect of the capital increase is such conversion, there is a considerable risk that the capital increase will not be accepted as having been properly conducted during a subsequent review, for example by a trustee in insolvency. The consequence, as outlined above in Section 2.5 is, that the shareholder remains liable to contribute the cash which he undertook to contribute, since the cash contribution with subsequent conversion will not be accepted.

In conclusion, no general advice can be proffered in this situation; each case has to be regarded as to its merits in view of the protective intent pursued by capital maintenance rules.

A capital reduction, to the extent funded out of capital reserves or paid up surplus, simply requires a written shareholder resolution. A capital reduction aiming to return some of the stated capital is more complicated and time consuming: There is not only a shareholder resolution, this time required in notarial format (because the articles are changed with respect to the capital number as stated), the resolution has to be published in the Federal Gazette, a one year waiting period has to lapse from the date of publication (during which creditors who so wish can be repaid or secured) and, finally, the reduction is recorded in the commercial register of the *GmbH* – only then will it be permissible to repay the capital.

### 3.2.6 Approved Capital

Whereas the German stock corporation has always had the possibility of creating approved capital which could be mobilised by management within a period of five years from its creation through issuing new shares against contributions, in the past this was not possible for the *GmbH*. The recent adoption of the approved capital structure creates welcome additional and equivalent flexibility for the *GmbH*.

There is not only the increased speed in which the approved capital can be used, there is also no (expensive and time consuming) change necessary to the articles when new shares are issued by management based on the approved capital, although some of these aspects are currently still in doubt.

### 3.2.7 Upstream Loans, Cash Pool

The Federal Supreme Court in its decision of November 2003 determined that upstream or side-stream (but not downstream) loans were only permissible for a *GmbH* under very tight limitations. This created problems for international groups since the operation of international cash pools had to pay special tribute to German corporate law restrictions and the risk of director liability in case of violation.

The reform tries to strike a balance between the *GmbHs* interest to gain access to liquidity and the group's interest in reducing financing costs. It clarifies that a *GmbH* may participate in a cash pool for as long as its exposure is covered by a

fair market value recourse claim against the parent company (or the sister company operating as group financing company, respectively) or in the event it is covered by a domination or profit and loss pooling agreement to similar effect.

This creates an additional onus on directors, since they have to judge at all times whether the parent company has sufficient liquidity for repayment of any cash pool loans made by the group *GmbH*. There is still a personal liability risk for directors in case this assessment goes wrong.

### 3.2.8 Piercing of Corporate Veil

Case law has devised a number of situations where the corporate existence of the *GmbH* is no longer respected and shareholders are held liable for obligations owed by the *GmbH*. The following shall illustrate the piercing of the veil in two of the most relevant examples.

#### 3.2.8.1 Equitable Subordination

A *GmbH* may find itself in a situation, where it cannot obtain loan financing at market conditions, because it is not sufficiently creditworthy, for example by reference to losses incurred or insufficient equity. If in this situation a shareholder either grants a loan or directly or indirectly guarantees a loan extended to the *GmbH* by a third party, this loan is treated just like equity in the event of insolvency of the *GmbH*. This means that a shareholder who received repayment of such loan prior within a period of 12 months prior to insolvency or where the loan was repaid to the third party, thus relieving the shareholder from his guarantee obligation, the shareholder will be required to reconstitute the loan amount to the trustee in insolvency. The respective loan is deemed to replace equity and, as a result, it is treated as second ranking insolvency claim. These consequences must be kept in mind whenever the financing requirements of a *GmbH* are met by means other than a contribution to capital.

#### 3.2.8.2 Equitable Subordination

Case law by the Federal Court created a potential liability for parent companies for liabilities owed by subsidiaries under integrated management by the parent company and without respecting the corporate identity of the subsidiary, e.g. by

commingling of funds. Integrated management is present whenever the management of the subsidiary is run in accordance with instructions from the parent company and certainly in every case where managing directors hold this position both in the parent and in the subsidiary.

This case law has the effect that a parent company may become liable to all liabilities of its subsidiary, if there had been insufficient consideration given to the business interests of the subsidiary. In case of an insolvency of the subsidiary this means that creditors of the subsidiary could turn to the parent to obtain satisfaction in respect of their receivables.

This case law has not yet been applied to non-resident parent companies, but the rationale evident in the decisions would equally apply to non-resident parents.

Academic commentary criticises this line of decisions as needlessly piercing the corporate veil in situations where other remedies are available in German law. Further, this case law may be in violation of EU company law.

A new line of case law applies personal liability to both shareholders and *GmbH* management, if *GmbH* funds are misused for shareholder purposes. This issue can be particularly relevant in group financing situations, such as cash pooling, see above.

### 3.2.9 Annual Accounts and their Publications

Management is responsible for operating the *GmbH* with an accounting system which will render accurate, reliable and timely information on the property, financial and income situation of the *GmbH*. German tax law requires monthly preliminary filings in respect of VAT, wage tax and social security. These must be derived with reliability from the accounting information prepared within the *GmbH*. During the start-up phase, German subsidiaries of foreign companies will normally employ the services of local bookkeepers and accountants to set-up the accounting system of the *GmbH* in a manner, which is assured to satisfy German formal requirements. When installing a foreign accounting system in a *GmbH*, there may be problems in meeting special requirements under German accounting and tax rules which, if not met, could result in financial disadvantages.

The outsourcing of accounting work to a non-German provider (whether affiliated or not) requires the prior consent by tax authorities. Violations can trigger penalties and challenges to the result of the accounting work.

Within three months from the end of its fiscal year, management of the *GmbH* has to prepare its annual financial statements comprising a balance sheet, profit and loss account and notes, have same audited and submit them to the shareholders for their approval.

Companies are sorted by size criteria to determine their respective accounting, auditing and publication requirements as follows:

	Mini Company	Small Company	Medium-sized Company	Large Company
Balance Sheet Total	≤ EUR 350,000	≤ EUR 4,840,000	≤ EUR 19,250,000	> EUR 19,250,000
Net Turnover	≤ EUR 700,000	≤ EUR 9,680,000	≤ EUR 38,500,000	> EUR 38,500,000
Average Number of Employees during the Financial Year	≤ 10	≤ 50	≤ 250	> 250

These criteria are currently being reviewed by the legislator. At the time of writing it is likely that the above criteria will be replaced by the following criteria.

	Mini Company	Small Company	Medium-sized Company	Large Company
Balance Sheet Total	≤ EUR 350,000	≤ EUR 6,000,000	≤ EUR 20,000,000	> EUR 20,000,000
Net Turnover	≤ EUR 700,000	≤ EUR 12,000,000	≤ EUR 40,000,000	> EUR 40,000,000
Average Number of Employees during the Financial Year	≤ 10	≤ 50	≤ 250	> 250

Any two of the three requirements count, provided they have been exceeded for two years running. For a start-up company, it is its first years numbers which count.

The size of the company determines when the annual accounts have to be prepared, whether there is an audit requirement and the extent of accounting information to be published in accordance with the following summary:

	Mini Company	Small Company	Medium-sized Company	Large Company
Preparation of Annual Accounts	Within 6 months after the end of the fiscal year	Within 6 months after the end of the fiscal year	Within 3 months after the end of the fiscal year	Within 3 months after the end of the fiscal year
	Simplified balance sheet.	Certain balance sheet items can be combined	Standard Balance Sheet	Standard Balance Sheet
	Simplified profit and loss account	Certain items of the profit and loss accounts can be combined	Certain items of the profit and loss accounts can be combined	Standard Profit and Loss Accounts
	No notes required.	Abbreviated notes	Abbreviated notes	Standard notes
Audit Requirements	No audit required	No audit required	Annual Accounts to be audited	Annual Accounts to be audited
Disclosure Requirements	Disclosure of balance sheet or deposition in electronic form	Balance sheet and notes to be disclosed	Balance sheet and notes to be disclosed	Full Disclosure

The shareholders will normally vote to approve the financial statements, to approve the actions of the managing directors during the fiscal year just passed (unless there is specific cause for complaint) and resolve on the use of the profit or loss. Such vote has to be taken within eight (in the case of a mini or small *GmbH* within eleven) months of the close of the respective fiscal year.

### 3.2.10 Distributions

#### 3.2.10.1 Dividends

The shareholders are free to distribute any excess of funds over and beyond the stated capital as dividends. The shareholders may also resolve on advance dividends prior to the end of the current fiscal year, provided the interim numbers of the *GmbH* show that sufficient funds are and will be available by year end to justify the advance distribution and provided such advance dividends are regulated in the Articles.



On the other hand, shareholders and managing directors at all times have to make certain that dividends are not paid from funds which are needed to maintain the stated capital. Any distribution to shareholders from funds needed to maintain the stated capital will trigger a statutory refund claim for the *GmbH*, which must be enforced by its managing directors. In addition, the managing directors become personally liable for any funds, which they distribute to the detriment of the stated capital.

### 3.2.10.2 Constructive Dividends

Occasionally, the *GmbH* is faced with shareholder proposals or actions to obtain or render products or services from or to shareholders at prices which do not correspond to market rates to the detriment of the *GmbH*. To the extent that the price differential is deemed to have been met from funds necessary to maintain the stated capital, German corporate tax law will characterise any deviation from the market price to the detriment of the *GmbH* as a constructive dividend, which will trigger a *GmbH* refund claim against the shareholder.

In addition, there is exposure to substantial tax disadvantages, since tax authorities will equally not accept terms and conditions in dealings between shareholders and their *GmbH*, which in deviating from market rates reduce the taxable result of the *GmbH*.

### 3.2.11 Co-determination

#### 3.2.11.1 Works Council

The *GmbH* is subject to two levels of co-determination:

The first level is at the shop floor through the works council. In any *GmbH* with at least 5 employees (not counting the managing director), the employees have the right to constitute a works council and elect one council member. In larger companies, the council membership will increase according to the following schedule:

Employees

Number of Works Counsellors

5 - 20	1
21 - 50	3
51 - 150	5
151 - 200	7

Etc.

The works council has certain information and co-determination rights. All organisational matters affecting employees require the works council's consent prior to implementation. The same applies to the hiring (only where the *GmbH* has more than 20 employees) and firing of employees which may not be undertaken without first giving the works council a hearing. If the works council should object to any such action, the *GmbH* can appeal to the courts to have the objection set aside.

In addition, the works council must be informed in advance on a variety of issues as determined in the Works Constitution Act.

### 3.2.11.2 Board Level Co-determination

A second level of co-determination is installed at board level. Under this type of co-determination a *GmbH* has to set up a Supervisory Board once it has more than 500 employees. The employees have the right to elect 1 / 3 of the members of the Supervisory Board.

In the case of a *GmbH* with more than 2,000 employees, employees have the right to elect 1 / 2 of the members of the Supervisory Board. However, the Chairman of the Supervisory Board will at all times be shareholder appointed and he holds the casting vote in the event of a tie.

In general, German experience with the two levels of co-determination has been positive. In particular the shop floor representation in the works council provides a platform for meetings between management and employees, which is

particularly useful in diffusing potential conflicts before they erupt into industrial action.

### 3.2.12 Liquidation / Cancellation / Insolvency / Salvage Measures

#### 3.2.12.1 Liquidation

The shareholders may at any time resolve to liquidate the *GmbH*. With the liquidation resolution, the *GmbH* changes its character from being run to obtain profits to being run for winding up purposes.

The office of the managing director ends with the liquidation resolution and the shareholders would normally appoint a liquidator. There is no special requirement as to the person or personal qualification of the liquidator, except that it has to be a natural person. Frequently, the last managing director(s) will be appointed liquidator(s). In the absence of a resolution, the last managing director(s) will be ex officio liquidator(s).

The liquidation resolution has to be published in the electronic Federal Gazette. Following the publication, there will be a one-year liquidation period. During this liquidation period, the creditors of the *GmbH* will be paid off to the extent possible. At the end of the liquidation period, the liquidator will file an application with the commercial register to have the company struck off the register together with an affidavit that creditors have been paid off. Following the striking of the *GmbH*, any residual funds may be distributed to shareholders in proportion to their *GmbH* shares.

Effective the beginning of the liquidation period, the *GmbH* has to prepare its last annual statement and file a tax return effective the same date. Thereafter, a financial statement for liquidation purposes has to be prepared annually, but tax returns can be filed in such a manner that they comprise the entire liquidation period.

#### 3.2.12.2 Cancellation of Defunct Companies

The liquidation of a *GmbH* creates costs. In a situation where the *GmbH* has no assets left and only owes (subordinated) receivables to its shareholders, it may

be advantageous to use a less expensive "quick fire" liquidation procedure. This is provided for under specific statutory cancellation rules.

For the *GmbH* to have no assets left, this can be arranged by having it sell off or assign whatever assets there are against arm's length consideration for settlement of liabilities. Once this is achieved, the managing director may file with the commercial register a balance sheet showing zero assets and requesting that the company be struck off the register for lack of assets. The commercial register will investigate, and, upon confirmation of the zero asset position, strike the *GmbH* from the register without a formal liquidation procedure. Tax compliance should be up-to-date since the local tax office will be given a hearing on whether the cancellation should go ahead.

### 3.2.12.3 Insolvency

*GmbH* statute provides for involuntary winding up in an insolvency situation. An insolvency situation is present if either

- the *GmbH* is unable to meet its current payment obligations or
- the *GmbH* has an excess of liabilities over assets, unless the *GmbH* has a going concern prospect.

If either situation arises, management must file for insolvency proceedings without undue delay, but in no event later than three weeks, to avoid criminal (and possibly personal) liability.

In the first case, the inability to meet payment obligations must not be merely temporary. If it is certain beyond reasonable doubt that the *GmbH* will acquire sufficient liquidity to pay its debts when they become due within a short period, this need not constitute a insolvency situation. However, this situation must be carefully reviewed and monitored.

In the second case, it is not just the book values of such assets and liabilities as shown in the last available balance sheet of the *GmbH*, rather, unrealised reserves have to be taken into account (minus any tax to be incurred in the realisation), for example from assets which are not capitalised (e.g. intangibles

created by the *GmbH* itself) and undervalued assets are assessed at their market value (e.g. real estate, buildings, etc.). On the other hand, necessary liquidation expenses (e.g. the need to finance a social plan) have to be taken into account in assessing all liabilities. Liabilities need not be taken into account if they are subject to subordination.

If in consideration of the above, the *GmbH* still shows an excess of liabilities over assets, insolvency proceedings may have to be applied for by management.

#### 3.2.12.4 Salvage Measures

In both cases of insolvency, shareholders may intervene to avoid commencement of insolvency proceedings.

In case of illiquidity, they may make additional liquidity available by way of capital increase, shareholder loans or other instruments, such as a comfort letter.

Whenever a shareholder meets the capital needs of the *GmbH* by granting a loan in a situation, where such *GmbH* would not have qualified for a loan from third party sources, such as banks, due to its doubtful financial position or lack of collateral, such shareholder loan will be treated as "deemed capital". This has the consequence that such loan may not be serviced with interest or repayment, for as long as the loan retains its deemed capital function. Specifically, any repayment of the loan to the shareholder will expose the shareholder to restitution proceedings in a subsequent insolvency. Having made the loan available in lieu of a capital contribution, the shareholder will be treated in law as if he had in fact contributed capital (see Section 3.2.8.2. above).

In the event of a net asset deficit, shareholders could again intervene by way of capital increase, by way of waiver of intercompany receivables or by way of subordination of claims as follows: The capital increase contributes fresh assets to the *GmbH* against issuance of new shares and in this way remedies the net asset deficit. On the other hand, the capital increase provides for a long-term enhancement of capital, which may not always be necessary for the *GmbH*. A

capital increase can also be achieved simply through payment of fresh cash to the paid-up surplus of the subsidiary.

The second possibility of waiving (same as contributing) an intercompany receivable will improve the net asset position by cancelling a liability. To the extent the nominal value of the claim waived exceeds its own fair market value, the waiver will result in a taxable gain. This gain is normally offset by the loss carried forward for tax purposes, but need not be. Under current tax law 2004 only the first EUR 1 million and 60% of the excess of taxable income can be offset against the loss carry forward, the residual 40% attracting tax. For this reason, the waiver has to be carefully considered in view of its tax consequences. At any rate, the waiver should always be expressed subject to a condition subsequent with the result that the claim waived is subsequently clawed back upon the company becoming profitable again, in this way reversing the taxable gain incurred originally. The amount waived - to the extent the nominal value corresponds to the fair market value of the claim - is, for tax purposes, treated as non-taxable shareholder contribution and may be repaid to the shareholder once the crisis is over without incidence of German taxes.

The third method of remedying a net asset deficit is the "subordination of claims". This denotes an undertaking on the part of a creditor, normally on the part of a shareholder and its affiliated companies, not to take repayment of an intercompany receivable for as long as the net deficit position of the *GmbH* persists. This undertaking has the effect that in an insolvency situation the non-subordinated creditors will take preference in having their receivables serviced over the receivables of the subordinated creditor. Once a subordination has been agreed upon between *GmbH* and the respective creditor, the subordinated receivables must be frozen and, in addition, they may not be serviced with interest for as long as the net asset deficit situation persists. Additional care must be taken in this situation, since a long-term non-interest bearing payable will, for German tax purposes be discounted to present value and the discount constitutes taxable income. According to tax authority thinking the discount will be taken over 13 years in case the repayment date of the payable is not determined. This discount, if it is in excess of EUR 1 million, will trigger taxes irrespective of any loss carried forward on 40% of the excess beyond EUR 1 million, see above.



# Doing Business in Germany



# Typically German

*The name "Dachshund" is of German origin and literally means "badger dog", from Dachs ("badger") and Hund ("dog"). Because of their long, narrow build, they are sometimes nicknamed hot dog dog, wiener dog or sausage dog. Although "Dachshund" is a German word, in modern German they are also commonly known by the name **Dackel**; for the formally certified hunting and tracking rank, the name **Teckel** is used.*

\* Texts taken from publicly available sources (Internet etc.)



## 4 ACCOUNTING, REPORTING AND AUDITING

### 4.1 Books and Records, Annual Financial Statements – General

Generally, in Germany every entrepreneur (and therewith every company in terms of commercial law) is obliged to keep books and records in accordance with German generally accepted accounting principles (German GAAP, *Grundsätze ordnungsgemäßer Buchführung, GOB*) in order to systematically track business related events. The bookkeeping contemporaneously serves as a basis for the annual financial statements (*Jahresabschluss*).

Such annual financial statements, including a balance sheet (*Bilanz*) and a profit and loss statement (*Gewinn- und Verlustrechnung, GuV*), have to be prepared within a certain time frame following the end of a fiscal year. The annual financial statements shall be clearly structured. Corporations (*Kapitalgesellschaften*) and certain partnerships are obliged to add notes (*Anhang*) and an annual report (*Lagebericht*) to the annual financial statements.

German GAAP generally is codified in the German commercial code (*Handelsgesetzbuch, HGB*). However, statute provides that, under certain circumstances, the International Financial Reporting Standards (IFRS) apply additionally. This is true for consolidated financial statements of listed companies which are established and have their statutory seat in the European Union or European Economic Area as well as for German companies which have voluntarily opted for additional reporting under IFRS.

The books and records, as well as the annual financial statements, must be prepared in such a way that an independent competent individual would be able to familiarize himself with the business, its transactions and its position within a reasonable period of time. The annual financial statements shall be prepared in German and the figures have to be expressed in EUR. All entries into the company's books must be made in a complete, correct, timely and systematic manner. Non-compliance may trigger unfavorable tax consequences and result in administrative fines and / or criminal prosecution. Furthermore, only such books kept in accordance with German GAAP imply evidentiary value in court proceedings.

The so-called EU Accounting Directive (Directive 2013 / 34 / EU of June 26, 2013), which has to be transformed into German law by July 20, 2015, will result in several amendments to the provisions of the German commercial code governing the accounting, auditing and reporting requirements to be observed by companies as well as by groups. The Federal government published a draft transformation bill on January 7, 2015. It should be noted, however, that the draft transformation bill may see further changes when and while it is pending in the parliamentary procedure. The information provided below is only preliminary and should therefore be reconfirmed with local counsel once the transformation bill has entered into force.

**4.2 Accounting, Auditing and Reporting Requirements for Corporations and Certain Partnerships**

**4.2.1 Categories**

For accounting, auditing and reporting requirements, German law currently provides for four categories of companies: (i) mini-sized companies, (ii) small companies, (iii) medium-sized companies and (iv) large companies. Generally speaking, medium-sized and especially small and micro-sized companies are granted a number of exceptions as regards certain of their accounting, auditing and reporting obligations, in order to prevent such companies from unreasonable expenditures (please also see below).

The following table sets out the currently applicable thresholds to qualify as a micro-sized, small, medium-sized or large company. In order to qualify within one of the categories, two of the following criteria must be met in two consecutive years.

	Mini-sized Company	Small Company	Medium-sized Company	Large Company
Balance Sheet Total	≤ EUR 350,000	≤ EUR 4,840,000	≤ EUR 19,250,000	> EUR 19,250,000
Net Turnover	≤ EUR 700,000	≤ EUR 9,680,000	≤ EUR 38,500,000	> EUR 38,500,000
Average Number of Employees during the Financial Year	≤ 10	≤ 50	≤ 250	> 250

A newly established company will qualify in one of the three categories, if two of the above-mentioned criteria are met at the end of the first financial year. Capital market-oriented companies such as listed stock corporations are always treated as large companies.

The Accounting Directive will, *inter alia*, result in an increase of the applicable thresholds for Balance Sheet Total and Net Turnover applicable to small companies, medium-sized companies and large companies as shown by italic letters below:

	Mini-sized Company	Small Company	Medium-sized Company	Large Company
Balance Sheet Total	≤ EUR 350,000	≤ <i>EUR 6,000,000</i>	≤ <i>EUR 20,000,000</i>	> <i>EUR 20,000,000</i>
Net Turnover	≤ EUR 700,000	≤ <i>EUR 12,000,000</i>	≤ <i>EUR 40,000,000</i>	> <i>EUR 40,000,000</i>
Average Number of Employees during the Financial Year	≤ 10	≤ 50	≤ 250	> 250

Based on the draft transformation bill, companies shall be able to apply the new thresholds to annual financial statements established for fiscal years beginning after December 31, 2013. The draft bill provides that the new thresholds shall become mandatory for fiscal years beginning after December 31, 2015. It should be noted that the increase of the threshold for Net Turnover will be accompanied by an amendment of the definition of Net Turnover. The new definition for Net Turnover will be broader in that it will also include revenues which do not stem from the ordinary business activity of the respective company.

### 4.2.2 General Accounting, Auditing and Reporting

The legal representatives of a corporation are required to prepare the corporation's annual financial statements (including a balance sheet (*Bilanz*), profit and loss statement (*Gewinn- und Verlustrechnung*), notes (*Anhang*) and annual report (*Lagebericht*)) within the first three months following the end of the applicable fiscal year or, in case of small companies, within the first six months following the end of the applicable fiscal year. Small companies are not required to have their annual financial statements be audited. The annual financial statements of medium-sized and large companies must be audited by a certified

public accountant, and ratified and approved by the shareholders of the corporation (or, in case of a stock corporation, by the supervisory board). The annual financial statement must be filed with the Electronic Federal Gazette (*Elektronischer Bundesanzeiger* – [www.ebundesanzeiger.de](http://www.ebundesanzeiger.de)) within 12 months after the end of the applicable fiscal year.

As mentioned above, a number of exceptions apply to small and medium-sized companies with respect to their accounting, auditing and reporting obligations. An abstract is given in the table below:

	Mini-sized Company	Small Company	Medium-sized Company	Large Company
Preparation of Annual Accounts	Within 6 months after the end of the fiscal year	Within 6 months after the end of the fiscal year	Within 3 months after the end of the fiscal year	Within 3 months after the end of the fiscal year
	Simplified balance sheet.	Certain balance sheet items can be combined	Standard Balance Sheet	Standard Balance Sheet
	Simplified profit and loss account	Certain items of the profit and loss accounts can be combined	Certain items of the profit and loss accounts can be combined	Standard Profit and Loss Accounts
	No notes required	Abbreviated notes	Abbreviated notes	Standard notes
Audit Requirements	No audit required	No audit required	Annual Accounts to be audited	Annual Accounts to be audited
Disclosure Requirements	Disclosure of balance sheet or deposition in electronic form	Balance sheet and notes to be disclosed	Balance sheet and notes to be disclosed	Full Disclosure

The exercising of the above-mentioned exceptions is voluntary, i.e. mini-sized, small and medium-sized companies can also opt for a comprehensive accounting, auditing and reporting.

### 4.3 Consolidated Annual Financial Statements

A parent company located in Germany, whose size exceeds certain thresholds and which controls at least one subsidiary (*Mutterunternehmen*) has to prepare

consolidated annual financial statements (*Konzernabschluss*), including consolidated balance sheet (*Konzernbilanz*), consolidated profit and loss accounts (*Konzerngewinn- und -verlustrechnung*), consolidated notes (*Konzernanhang*), a cash flow statement (*Kapitalflussrechnung*) and a statement on the consolidated equity (*Eigenkapitalspiegel*). In addition, a consolidated annual report (*Konzernlagebericht*) must be prepared.

The consolidated annual financial statements shall be drawn up in accordance with German GAAP and shall give a true and fair view of the financial position, the financial performance and the cash flow of the group. It has to be prepared within four months after the end of the relevant fiscal year of the parent company. The consolidated annual financial statements do not supersede the individual annual financial statements of the subsidiaries.

Under the current legislation in force, a consolidated annual financial statement has not to be drawn up in case the German parent company is a subsidiary of another (holding) company located in the European Union or the European Economic Area, if (i) the consolidated annual financial statements of this parent company include the German members of the group, and (ii) these annual financial statements are published in German in accordance with the applicable German laws. This exemption does however not apply if the German intermediate parent company is listed on a stock exchange.

A parent company is also exempt from the duty to draw up consolidated financial statements, if at least two of the three criteria under (A) or (B) below are met at the close of the fiscal year of the annual financial statements. These criteria, however, will be amended in connection with the contemplated transformation of the Accounting Directive into German law as shown in square brackets below. Based on the draft transformation bill, parent companies will be able to apply the new thresholds to consolidated financial statements established for fiscal years beginning after December 31, 2013. The new thresholds will become mandatory for fiscal years beginning after December 31, 2015:

(A)

- The sum of the balance sheet totals of the parent company and its subsidiaries to be included in the consolidated financial statements does not exceed EUR 23,100,000 [EUR 24,000,000];
- The sum of the turnover of the parent company and its subsidiaries to be included in the consolidated financial statements in the 12 months before the close of the fiscal year does not exceed EUR 46,200,000 [EUR 48,000,000]; and
- The parent company and the subsidiary did not employ on average more than 250 employees in the 12 months before the close of the fiscal year.

(B)

- The consolidated balance sheet total does not exceed EUR 19,250,000 [EUR 20,000,000];
- The consolidated turnover in the 12 months before the close of the fiscal year does not exceed EUR 38,500,000 [EUR 40,000,000]; and
- The parent company and the subsidiary did not employ on average more than 250 employees in the 12 months before the close of the fiscal year.

# Doing Business in Germany



# Typically German

**Sauerkraut** (*pickled cabbage*) is produced by lactic acid fermentation of cabbage and is usually eaten cooked as a side dish. It is internationally renowned as the most popular German dish.

\* Texts taken from publicly available sources (Internet etc.)



## 5 PRINCIPLES OF GERMAN TAXATION

### 5.1 Resident and Source Taxation

Anyone doing business or generating revenue in Germany may become subject to some form of German taxation. This taxation might relate to various types of taxes levied by federal, state or municipal authorities.

Just as in many other countries, German income taxation may be triggered under two different principles. The first and most far-reaching principle is taxing someone – whether individual or corporation – on worldwide income. As the term "worldwide" already suggests, this form of taxation is not linked to the source of income. As this is a very far-reaching regime, it is only applied to those taxpayers who are deemed to be resident in Germany for income tax purposes.

A natural person is deemed to be tax resident in Germany, if the person has one (of possibly many) domicile(s) or his or her habitual place of abode in Germany. For corporations, tax residency is determined by the statutorily registered office of a company or its place of management. The place of management is the place where the day-to-day business decisions are being made. These decisions may be taken by the managers of a company, regardless of whether they are appointed legal representatives of a company, such as the managing directors of a *GmbH* (*Geschäftsführer*) or the members of the management board of an *AG* (*Vorstand*), or not.

The second principle which may trigger taxation in Germany is based on the source of income. Under this principle, Germany taxes income deemed to be derived from a German source. The German Income Tax Act provides for an exhaustive catalogue of income derived from German sources. The most important German sources of income are:

- Income attributable to a German permanent establishment;
- Income from the sale of a significant shareholding in a corporation with its registered office and / or place of management in Germany (a shareholding is significant if it represents at least 1% of the issued share capital);
- Rental income or income from the sale of immovable assets located in Germany;
- Employment income, if work is done in Germany; and
- Salary of legal representatives (wherever located) of a corporation with its place of management in Germany.

*The most significant difference between tax upon residency or source is that in the latter case, only the income actually derived from the German source is taxed in Germany. The allocation of income – especially when looking at activities of a German permanent establishment – often gives rise to disputes with the German tax authorities.*

## **5.2 Foreign Income / Double Taxation**

### **5.2.1 General Overview**

As German tax residents are taxed on the basis of their worldwide income and as foreign income may have already been taxed in the country of source, there is a risk of double taxation. Germany applies – like most other countries – two systems to mitigate double taxation of foreign income.

On the one hand, Germany is party to many conventions for the avoidance of double taxation, referred to as double tax treaties. On the other hand, Germany applies a tax credit in situations where there is no double tax treaty. A tax credit is granted in Germany, if the tax levied abroad is comparable to German income taxes (i.e. a profit tax based on net profits).

*There is a basket system which ensures that foreign taxes credited do not exceed the German tax levied on the same item of income, and that the credit is only applied on a country by country basis. German legislation does not provide for a unilateral exemption for foreign income absent a double tax treaty.*

### 5.2.2 Double Tax Treaties

Double tax treaties aim at avoiding double taxation. Double taxation may generally be defined as the imposition of comparable taxes in two (or more) states on the same tax payer in respect of the same subject matter and for identical periods.

For the purpose of eliminating double taxation, double tax treaties usually establish two categories of rules:

- The first set of rules allocates, with regard to different categories of income, the respective right to tax such income either to the state of source or situs or to the state of residence.
- For a number of items of income and capital, an exclusive right to tax is conferred on one of the contracting states. This prevents the other contracting state from taxing those items and as a result, double taxation is avoided. As a general rule, this exclusive right to tax is conferred on the state of residence. In the case of certain items of income, the right to tax is non-exclusive. For example, dividends and interest may be taxed in both contracting states but the amount of tax that may be imposed in the state of source could be capped. In this case, the provisions confer on the state of source or situs a full or limited right to tax. At the same time, the state of residence is obliged to allow relief for the tax imposed by the state of source so as to avoid double taxation.

The treaties regularly leave it to the contracting states to choose between two methods of relief, i.e. the exemption method and the credit method.

- Exemption method: income or capital that is taxable in the state of source or situs is exempted from taxation in the state of residence, but it may be taken into account for determining the rate of tax applicable to the tax payer's other income or capital.
- Credit method: income or capital that is taxable in the state of source or situs is subject to tax in the state of residence, but the tax levied in the state of source or situs is credited against the tax levied by the state of residence on such income or capital.

In most of the treaties to which Germany is a party, both methods are applied, depending on the type of income.

## **5.3 Taxable Income – All Business Operations**

### **5.3.1 Financial and Tax Accounting**

The taxable income and, thus, the tax liability of a business operation in Germany – whether corporate, partnership, branch or single entrepreneur – is derived from its financial accounts established under German generally accepted accounting principles. Generally speaking, the tax accounting follows the financial accounting with the consequence that the result shown in the financial accounts will be the starting point for determining the profit (or loss) which is subject to tax.

### 5.3.2 Special Rules for Tax Accounting and Valuation

Tax law, in particular the German Income Tax Act in its periodically revised form, stipulates certain rules, which must be followed when determining taxable income. To the extent the financial accounts follow different rules, the result has to be re-calculated for tax purposes according to the rules of the German Income Tax Act. By way of illustration: for financial accounting purposes intangible assets may be capitalized regardless of whether they are self-produced or have been acquired from other parties, whereas for tax accounting purposes intangible assets acquired for a consideration have to be capitalized and self-produced intangibles may not be capitalized at all.

Furthermore, the financial accounting rules in many instances accord discretion both as to whether or not certain assets are capitalized or certain liabilities are posted or not, and as to the methods of, inter alia, valuation and depreciation. Case law has decreed that wherever there is discretion in the financial accounts whether or not to capitalize an asset, such discretion shall, for tax purposes, be deemed to have been exercised in favor of capitalization. In contrast, in the event that there is discretion whether or not to record a liability, such discretion shall be deemed to have been exercised against recording the liability.

The result, which is subject to tax, is established under this system of interaction between financial and tax accounting rules.

### 5.3.3 Capital Gains and Rollover

As a matter principle, there are no special capital gains tax rates applicable for capital gains realized as part of the ordinary business income. However, capital gains may qualify for a tax-free rollover if they are derived from the sale of real estate and buildings and certain other defined assets which have been held for more than six years by the business realizing the gain. Rolled over capital gains have to be used within a period of four years. Special exemption rules apply with respect to capital gains realized from the sale of shares, as further discussed below.

### 5.3.4 Arm's Length Criteria and Transfer Pricing

German tax authorities have wide powers under German law to investigate whether the reported taxable income arises out of arm's length transactions. In situations where expenses or income of an affiliated German company from transactions with other affiliates are not in line with what would be appropriate for an independent business, German tax authorities have the power to adjust either expenses or income in order to arrive at an arm's length result which then becomes subject to tax. Rules in effect since 2003 require companies with foreign affiliates to prepare comprehensive transfer pricing documentation. This documentation must be prepared contemporaneously for extraordinary business transactions (i.e. within six months after the end of the financial year in which the transaction occurred). For all other transactions do not have to be documented contemporaneously but have to be submitted within 60 days upon request by the tax authorities, usually in the context of a tax field audit.

*Small Companies having only limited intercompany transactions with related parties are exempt from the most onerous of these reporting and documentation obligations.*

### 5.3.5 Intercompany Charges

Business expenses incurred in relation to intragroup transactions, such as interest paid on intercompany loans, management fees, technical assistance charges, or royalties on intellectual property rights are tax-deductible expenses, provided that they were incurred in the business interest of the German affiliate and calculated on an arm's length basis and certain formal requirements are met.

With regard to the relationship between an operating company and its branch Germany, in principle, follows the Authorized OECD Approach according to which the branch is treated like a "separate entity" as far as possible. This implies that "dealings" between headquarters and branch have to be based on arm's length principles. Taxpayers are requested to prepare specific branch accounts taking into account assets and liabilities allocable to the branch and

the results of dealings. The accounts have to be ready when the tax return is filed at the latest.

### 5.3.6 Tax Rulings

German tax law offers the possibility to obtain advance tax rulings for certain not yet executed business transactions, if the taxpayer has a special interest in knowing the tax treatment of such transactions in advance. Such binding tax rulings trigger administrative fees, the amount of which depends on the value of the subject matter and may go up to more than EUR 100,000.

In terms of transfer pricing, both unilateral advance approval and bilateral / multilateral Advance Pricing Agreements (APAs) are available in Germany. However, the Federal Ministry of Finance issued administrative regulations stipulating that in cases where a double tax treaty contains a clause on mutual agreement procedures with the country of the foreign enterprise, the German taxpayer should not be granted a unilateral advance approval but advance rulings may only be obtained by way of bilateral APA. Where no double tax treaty exists, the tax authorities may on request provide the taxpayer with a unilateral APA which can have various legal forms, provided that the specific case is appropriate and provided legitimate interest exists.

### 5.3.7 Loss Carry Forwards and Minimum Taxation

Losses can be carried back for one year. This is, however, limited to a total amount of EUR 1,000,0000.

There is no time limitation for carrying forward tax losses. However, existing tax loss carry forwards can usually not be used in their entirety to set off the income of a given year. While the first EUR 1,000,000 of income of a given year can fully be set off by the loss carried forward, only 60% of any excess income can be. The residual 40% of income of a given year becomes subject to tax irrespective of the availability of a tax loss carry forward.

Existing tax losses will be cancelled in full if more than 50% of the share capital of a corporation is acquired by a purchaser (or a group of related purchasers) within a 5 year period. If there is a change of ownership of more than 25% up to



50%, tax losses will be cancelled on a pro rata basis. The same rule applies to transactions with a similar effect, e.g. change of voting right commitments or the indirect change of ownership at a higher level in the corporate holding chain. Exceptions to the change of control rules regarding the cancellation of loss carry forwards apply (i) where a transfer takes place between wholly-owned subsidiaries; or (ii) where the target company has unrealized gains, which, if realized, would be taxable in Germany.

### 5.3.8 Interest Barrier

The deductibility of interest expenses is limited by the interest barrier. The interest barrier essentially limits the deductibility of the net interest of a business (interest expenses less interest income of a given year) to 30% of the taxable EBITDA (Earnings before Interest, Tax, Depreciation and Amortization). The identity and residency of the creditor to whom interest is paid is principally irrelevant. Any interest which cannot be deducted in any one fiscal year can be carried forward subject to the carry forward cancellation rules applicable to loss carry forwards in general. Within certain limitations a carry forward for unused EBITDA volume is available.

Taxable EBITDA may substantially deviate from the financial EBITDA. This applies in particular to the receipt of tax exempt income, for example dividends which are part of the financial EBITDA but not of the taxable EBITDA. The same applies to income or loss from foreign permanent establishments that is exempt under an applicable double taxation treaty.

The interest barrier does not apply if the net interest accrued in a given year is below EUR 3,000,000. If this threshold is exceeded, the entire net interest falls under the barrier limitation. Subject to certain counter exceptions, the interest barrier rules do not apply, where a German business can show that its debt-equity ratio is not below 2 percentage points of the debt-equity ratio of the consolidated group. It is the debt-equity ratio at the end of the preceding fiscal year which determines the application of the interest barrier for the following year. There are a number of special rules applicable to the determination of equity for the accounts of the German company.

## 5.4 Trade Tax

German trade tax is a second type of income tax on business income. The trade tax income is based on the income for (corporate) income tax purposes and adjusted by certain add-backs and deductions. It is principally levied on any domestic business operation – whether corporate, partnership, branch or a single entrepreneur. Conceptually, trade tax is a municipal tax, but without granting municipalities the right not to levy the tax. The rates are determined individually by each municipality and typically range between 10% and 17.5% of taxable profits (calculated by 3.5% times the municipal trade tax multiplier). Trade tax is a non-deductible expense.

*Larger cities tend to levy higher trade tax rates, whereas more remote locations use a low trade tax rate as an incentive to attract investment.*

The business income computed according to income tax principles will be subject to certain modifications, e.g. the following amounts will principally be added back to the profit:

- 25% of interest and interest equivalents;
- 5% of the lease or user fee for movable assets;
- 12.25% of the lease or user fee for immovable assets;
- 6.25% of the lease or user fee for the licensing of rights.

As example, the following amounts will be deducted from the profits:

- Profits from partnerships and foreign branches;
- Dividends (provided that the tax payer holds at least 15% of the issued share capital from the beginning of the year);
- 1.2% of the assessed value of any real estate.

## 5.5 Taxation of Partnerships

For German income tax purposes a partnership is regarded as transparent. The net profit after trade tax generated by a partnership will be allocated to the partners as agreed in the partnership agreement. The allocated profit or loss is taxable as part of the income of the respective partners. A natural person who is a partner will pay Personal Income Tax, a corporate partner is in turn subject to Corporate Income Tax.

The allocation of losses is limited to the amount of capital at risk. By way of illustration, a limited partner having contributed EUR 100,000 in accordance with the partnership agreement will not be eligible for deducting losses in excess of EUR 100,000. Any loss which is not allocable by reference to this rule is carried forward for an indefinite period of time and may, to the extent defined by statute, be set off against future profits. It may also be activated earlier through an increase in the capital at risk. In the event of insolvency of the partnership any unallocated loss is allocated to the general partner(s).

All expenses associated with the partnership interest held by a partner, but incurred personally by such partner, whether as a resident or non-resident partner, whether in Germany or abroad (for example interest payable on a loan used to finance the acquisition of or contribution to the partnership), are treated as special partnership expenses. These can be deducted by the partnership for trade tax purposes and by the relevant partner for the purposes of assessing the profit allocable to the partner for personal income or corporate income tax purposes. This model is frequently used for "double dip structures", if the interest expense incurred by a non-resident partner is deductible both in Germany in connection with determining the partnership's profits and in the country of residence of the partner. Special partnership income arises, for example, from items of income generated by the partner from certain business transactions with the partnership, such as the rental of real estate owned by a partner and used by the partnership. The corresponding business expenses incurred by the partnership will be a deductible expense for the partnership, but will be added back as special partnership income for the respective partner.

Income allocated to a foreign corporate entity in respect of an interest in a German partnership will be treated as if that corporation maintained a taxable

permanent establishment in Germany. Likewise, foreign natural persons holding an interest in a German partnership will become subject to non-resident taxation on their partnership income or loss in Germany.

## 5.6 Taxation of Corporate Entities

### 5.6.1 Taxation System

The income of corporate entities is subject to corporate income tax, plus solidarity surcharge, and trade tax. Germany operates a classic system of corporate taxation applied at both corporate and shareholder level (on dividends).

### 5.6.2 Tax Rate Illustration

The corporate income tax rate is currently fixed at 15%, applicable to both retained and distributed profits. On top, a solidarity surcharge of 5.5% is levied on the corporate income tax. As a result, the effective tax burden without trade tax is 15.825%.

The total tax burden can basically be calculated as follows:

Municipal Trade Tax Multiplier (%; examples)	350%	400%	450%	490%
Profit before Taxes	100,00	100,00	100,00	100,00
Trade Tax (3.5 times multiplier)	12,25	14,00	15,75	17,15
Corporate Tax (15%)	15,00	15,00	15,00	15,00
Solidarity Surcharge (5.5% of Corporate Tax)	0,825	0,825	0,825	0,825
Profit after Taxes	71,925	70,175	68,425	67,025
Total Tax Burden	28,075	29,825	31,575	32,975

Based on the differences between the calculation of the profit for income tax purposes and trade tax purposes (see Section 5.4), the actual total tax burden might be subject to variation.

### 5.6.3 Taxation of Dividends and Capital Gains

For corporate entities, dividend income, whether received from a domestic or foreign corporation, is effectively 95% tax exempt for corporate income tax purposes, provided that the corporate shareholder holds at least a participation of 10% in the distributing entity at the beginning of the calendar year. As an exception from this rule, dividend income is not exempt to the extent the distributed amounts lowered the tax base of the distributing entity. For trade tax purposes, the 95% tax exemption for dividend income of a corporate shareholder principally only applies if the shareholder held at least 15% of the share capital of the distributing entity since the beginning of the calendar year.

Capital gains derived by a corporate shareholder from the disposal of shares are likewise effectively 95% tax exempt, unless the book value of the shares had been written down with tax effect in the past. In turn, capital losses suffered by a corporate shareholder from the disposal of shares are generally not tax deductible.

The corporate shareholder is entitled to deduct all expenses, relating to the shareholding, from his taxable income (including interest expenses), irrespective of the amount.

Special rules in respect of the taxation of dividend income and capital gains are applicable for certain companies belonging to the financial and insurance sector.

### 5.6.4 Constructive Dividends

Generally speaking, German tax law re-interprets intercompany pricing arrangements which do not satisfy the arm's length test. Expenses incurred by a German corporation in relation to an intercompany arrangement that is not at arm's length may for example be reclassified into a constructive dividend. As a consequence, there would be an off-balance sheet adjustment of the related expense item, thus increasing the entity's taxable income. The same rules apply where products or services sold by the German entity are charged at less than arm's length prices. A corresponding amount arriving at an arm's length sales price would be added back for calculating the entity's taxable income. The amount added back would be subject to trade tax, corporate income tax and solidarity surcharge and dividend withholding tax may apply as well.

At the shareholder level, the constructive dividend is treated like any other dividend, triggering dividend withholding tax. Normal withholding tax reductions and eliminations under the treaty or European Union Directives apply.

## 5.7 Real Estate Transfer Tax

The purchase of real estate located in Germany is subject to real estate transfer tax. Real estate transfer tax is levied on the consideration paid for acquiring the real estate and the rates depend on the state where the real estate is located: (i) 3.5% in Bavaria, and Saxony, (ii) 4.5% in Hamburg, (iii) 5.0% in Baden-Württemberg, Brandenburg, Bremen, Lower Saxony, Mecklenburg-Western Pomerania, Rhineland-Palatinate, Saxony-Anhalt, and Thuringia, (iv) 6.0% in Berlin, and Hesse, (v) 6,5% in North Rhine-Westphalia, Saarland and Schleswig-Holstein, of the purchase price.

The acquisition of shares in a company owning real estate is generally not subject to real estate transfer tax, unless a shareholding of at least 95% of the issued share capital of the company (whether indirectly or directly) is acquired by a purchaser (or a group of related purchasers). For partnerships owning real estate further transactions may trigger the tax. For example, the exchange of at least 95% of the partnership interests of a partnership within any five-year period (with respect to indirect or direct investment in the partnership's capital). In situations where real estate transfer tax is triggered by the transfer of shares or interests, the tax is assessed using a special valuation of the real estate property which is usually lower than the fair market value of the real estate. If there is evidence that the fair market value is lower than the tax assessed value, the lower fair market value will apply.

Reorganizations within groups of companies involving a direct or indirect transfer of real estate located in Germany may be exempt from real estate transfer tax. Basically, the intragroup exemption requires that the transaction occurs among a parent entity and their subsidiaries, provided that the parent has a minimum shareholding of 95% (directly or indirectly) and held its 95% stake for five years prior to the transaction and continues to hold such 95% stake for five years following the transaction.

*In order to avoid a violation of European Union rules, reorganization transactions under rules of other Member States of the European Union or the European Economic Area are equally exempt as purely domestic transactions. However, reorganization transactions under the laws of any non-European Union / European Economic Area countries are not privileged.*

## **5.8 Value Added Tax (VAT)**

In Germany, VAT is levied on the supply of goods and services both to private consumers and businesses. As a basic principle, only private consumption will effectively be burdened with VAT. Therefore, the input VAT invoiced by suppliers to businesses will generally be refunded to most types of businesses by the German tax authorities, provided that certain procedural requirements of the refund procedure are met (in particular, proper invoicing).

### **5.8.1 VAT Rate**

Two VAT rates apply to goods and services supplied in Germany: currently, the standard rate levied on goods and services is 19%, whereas a few services and certain privileged goods – mainly food products – are taxed at 7%.

### **5.8.2 Taxable Persons**

In principle, all natural and legal persons qualify as taxable persons, if they supply goods and / or services that are subject to VAT in Germany. This also applies to all foreign persons (individuals and foreign established companies), provided that they perform business activities under German VAT law with a relevant tax nexus to Germany. The services rendered by banks and insurance companies are not subject to VAT; as a result there is also no input VAT refund, so VAT remains a cost.

### **5.8.3 Taxable Activities**

The following examples show typical transactions that may trigger VAT obligations in Germany:

- Supply of services to a German customer or to a fixed establishment in Germany; certain supplies from Germany to foreign customers.
- Sale of goods within Germany or cross-border sale from German territory.
- Purchase of goods within the European Union, such as the purchase of a computer to be delivered from France to Germany ("intra-Community-purchase").
- The mere transport of own goods from other EU-countries into Germany ("deemed intra-Community-purchase"), such as transfer of goods from a French to a German warehouse.
- Likewise, the import of goods from non-European Union countries into Germany in certain cases ("import VAT"). In these scenarios, it is not the sale of goods, but rather the receipt of goods in Germany that is subject to VAT. VAT payments may typically be compensated by corresponding VAT refunds.
- Special types of supplies, such as supplies of goods free of charge, or sale of goods to or from Germany (as principal) through a commissionaire. Both cases may be deemed to be a taxable supply of goods: in the first case (supply free of charge), without particular recipient; in the second case, as a deemed supply by the principal to the commissionaire.

### 5.8.4 Special VAT Regimes / Exceptions

In Germany, several particular VAT regimes are available, allowing VAT structuring. Here are a few examples:

- Option for VAT: in certain situations, it may be preferable to voluntarily opt for VAT. For the sale of a house for instance, the seller may opt (in the notarized contract) that the sale (which by default would have been exempt from VAT) will be subject to VAT. As a result, the seller may profit from a full refund of his input VAT. The same is possible for financial services and the lease of real property under certain further conditions; for insurance services, on the other hand, no option for VAT is allowed.



- Acquisition of businesses into VAT group: a taxpayer that renders VAT-exempt services (such as financial services) is typically not entitled to get an input VAT refund from purchase invoices for the acquisition of taxable services. In certain cases it may therefore be advantageous to integrate the service providing company into a VAT group with the taxpayer. Consequently, the services supplied by the company to the taxpayer will no longer be taxable (VAT group internal services) and thus not trigger VAT payments.

*Opportunities for group companies: supplies rendered by companies that actively pursue a business are no longer taxable, if they qualify as a subordinate part of a tax group for VAT purposes.*

- Transfer of business as going concern (so-called "TOGC"): the sale of a business (or a business unit) may be exempt from VAT, if it qualifies as a separable business and is to be continued by the purchaser. Such relief may, for instance, be applied to certain asset deals or the sale of leased real estate as these often qualify as a "separate business unit".

*Properly drafted VAT clauses in the contract documents should reflect that the parties consider the transaction as qualifying for the VAT exemption; depending on the circumstances the clauses should include appropriate fall-back positions.*

# Doing Business in Germany

# Typically German

**Currywurst** is a fast-food dish of German origin consisting of hot pork sausage (German: *Wurst*) cut into slices and seasoned with curry sauce (regularly consisting of ketchup or tomato paste blended with curry powder, or a ready-made ketchup-based sauce seasoned with curry and other spices). It is frequently served at German *Imbissbuden* and from food vans.

\* Texts taken from publicly available sources (Internet etc.)



## 6 BANKING & FINANCE

### 6.1 Granting Loans - Requirement of a Banking License in Germany

Anyone wishing to conduct banking business or to provide financial services in Germany commercially, or on a scale that requires a commercially organized business undertaking, requires a written license.

Providers from non-EEA states that wish to market their banking and financial services products specifically in Germany must, therefore, establish a subsidiary or a branch in Germany in order to obtain the required license. It should be noted that such subsidiary or branch then may outsource certain activities to its foreign parent. However, in case of a German branch or subsidiary, the transaction conducted under the license must be booked at the German entity; the German subsidiary or branch may not be a mere "shell" company.

Banking business is defined conclusively in section 1 (1) German Banking Act (*Kreditwesengesetz, KWG*) by a list of twelve types of businesses that are deemed to constitute banking business. These include the acceptance of funds (deposit business), the granting of loans (lending business) and the purchase and sale of financial instruments (principal broking services).

The decisive factor for assessing the licensing requirements is generally the manner in which the negotiations relating to the loan have been initiated. If the foreign financial institution specifically targets the German market for the purpose of offering loan agreements repeatedly on a commercial basis to companies and/or persons that have registered offices or ordinary residence in Germany, this generally constitutes lending activities requiring a license (section 1 (1) sentence 2 no. 1 KWG). It is not clear to what extent involving or relying on affiliated companies' marketing activities can be deemed to be marketing activities of a foreign bank. However, it is frequently seen in the market that a German licensed bank markets and/or arranges a financing, while the booking is done through a facility office not being licensed in Germany.

If the foreign institution solicits clients in Germany to offer loans repeatedly and on a commercial basis, the license requirement is triggered. Assuming that such bank targets the German market wishing to lend money, a banking license would be required. Participating in a syndicated facility, however, does generally not trigger any licensing requirements.

Any sub-participation (and its enforcement) is generally possible without holding a banking license in Germany. It can even be done simultaneously with granting of the loan.

A license requirement will, only be triggered if the foreign bank actively solicits customers on the German market for this service. All types of promotional efforts directed at German residents, i.e. individuals and/or companies located in Germany, will trigger a license requirement, regardless of whether they take place on German soil or involve distance communication, including customer visits, mailings, internet offers or phone calls.

It should be noted that in relation to loan syndications, the German Federal Financial Supervisory Agency (*Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin*) assumes that in most cases banks are invited by the borrower or the lead manager to join the syndicate or win the mandate in a beauty contest to which they have been invited. The same might hold true for payment agents (also assuming that frequently, one of the lenders or an affiliate of a lender may assume this task). However, if in a concrete case, the bank was not invited by the borrower based in its general reputation or a recommendation, but actively promoted the business in Germany, this "assumption" will no longer apply.

## 6.2 Securing Loans

Under German law it is not market-standard and, ultimately, not possible to create security over all kinds of assets (shares, bank accounts, receivables, movable assets, fixed assets and the like) in one single security agreement. Hence, separate security agreements are required for different kinds of assets (i.e. share pledge, account pledge, assignment of receivables, security transfer of fixed and movable assets). This having said, it is generally possible to combine some, e.g. the assignment of several kinds of receivables against debtors, suppliers, account banks, insurance providers in a global assignment agree-

ment. Depending on the lender, such combination is more or less likely to be accepted.

Taking security over present and future collateral is possible and market-standard in Germany. In this context, it is absolutely necessary, however, that the pledged/ assigned assets are adequately defined or definable in order to meet the requirements of the German legal principle of certainty (*Bestimmtheitsgrundsatz*).

There is no registration requirement for any German security (except for security granted over real property).

Two very important points to bear in mind if dealing with German limited liability companies (*Gesellschaft mit beschränkter Haftung, GmbH*) and creating security over German assets are:

**Upstream Security – Limitation Language:** Under German law, granting security in favor of the shareholders and affiliated companies (other than subsidiaries, i.e. a company granting security over its assets for debt incurred by its Shareholders or affiliated companies might violate capital maintenance provisions and requires certain restrictions.

**Share Pledge - Notarial Fees:** German law requires a pledge over shares of a company to be notarised and the parties, or attorneys of the parties, need to appear before a German notary public. It is market-standard in Germany that the power-of-attorney of the security grantor (and the company, whose shares are pledged, if party to the share pledge) are notarised and, if the shareholder is located outside of Germany, legalised or apostilled. A share pledge is likely to cause substantial costs, as the notarial fees are calculated based on the value of the pledged shares.

Under German law the type of security depends on the asset classes available as collateral. It is not possible to take a floating charge or similar security over a business. The most common types of security in banking transactions involving German obligors are pledges in respect of shares and partnership interests, bank accounts and intellectual property rights, security assignments in respect of receivables and intellectual property rights, security transfers in respect of

movable assets and mortgages or land charges in respect of real estate.

## 6.2.1 Asset Security

Within the asset security one differentiates between accessory and non-accessory security. Accessory rights are dependent on the secured obligations and cease to exist if the secured obligation ceases to exist; non-accessory rights are independent from the secured obligation.

### 6.2.1.1 Share Pledge Agreement

The share pledge agreement is an accessory security which gives the pledgee the right to seek realization in the pledged shares of a German company after an event of default has occurred. At least for the perfection of a share pledge agreement concerning the shares in a GmbH, the share pledge agreement must be notarized (causing substantial costs). Additionally, the company, whose shares are pledged, needs to be notified for perfection of the pledge.

For the enforcement of the pledge, the competent German court of execution normally determines whether or not the pledged shares shall be sold by public auction or discretionary sale. In general, deviating agreements between the parties with respect to the realization of the pledge are possible, but may not be agreed upon before the maturity of the pledge. The public auction is conducted by a bailiff.

### 6.2.1.2 Intellectual Property Rights Pledge Agreement

The intellectual property rights pledge agreement ("**IP Pledge Agreement**") is an accessory security which gives the pledgee the right to seek realization in the intellectual property rights of the pledgor in case of maturity of the pledge. In other words, the pledgee shall have the power to sell the pledged IP rights by public auction upon the occurrence of the maturity of the pledge. The maturity of the pledge is not necessarily connected to an event of default; for the maturity of a pledge it is sufficient that the secured obligations become due and have not been satisfied by the obligor within a reasonable time period (normally five (5) business days). However, the parties tend to define the events of default resulting in the maturity of the pledge, in the IP Pledge Agreement.

In a standard IP Pledge Agreement the pledgor usually pledges all current and future intellectual property rights, including patents, trademarks, trade names, domains and all rights related thereto, whether registered or not, to the pledgee.

Copyrights on the other hand are not pledgeable in favor of third parties pursuant to Section 29, sentence 2 *German Copyright Act (Urheberrechtsgesetz, UrhG)*. However, since single exploitation rights connected to the copyrights may be transferred to third parties by granting them a right of use, those rights of exploitation can also be pledged in favor of third parties.

For the perfection of the IP Pledge Agreement no special form is required. Due to Section 34 UrhG the prior consent of the originator of a copyright is required in order to pledge those exploitation rights to a third party.

#### 6.2.1.3 Account Pledge Agreement

An account pledge agreement is an accessory security which gives the pledgee the right to seek realization after an event of default has occurred and with respect to which an acceleration notice has been given.

For the perfection of the account pledge agreement notification of the account holding bank is mandatory.

#### 6.2.1.4 Global Assignment Agreement

A global assignment is a non-accessory security which usually covers all present, future, actual and contingent receivables against any debtor, supplier, bank as well as insurance proceeds, indemnity claims, claims arising from any current or future account balance, intercompany claims and any claim arising from or in connection with guarantees and warranties granted to the borrower by a third party. In general, the assigned receivables do not only secure the redemption claims but all obligations owed by any assignor to a lender, whether present or future, actual or contingent.



The perfection of the global assignment does not require the prior consent of any debtor. However, due to provisions in the global assignment agreement the assignor is often required to inform the respective debtors of the assignment within two or more business days. Upon the occurrence of an event of default, the assignee is normally entitled to collect the sums directly in its own name and for its account from the respective debtors.

### 6.2.1.5 Security Transfer Agreement

In a security transfer agreement (non-accessory security) the transferor generally transfers all his present or future ownerships, co-ownerships, expectant rights in respect of his current and future assets, which are or will be located from time to time in the future within the designated security area to the transferee.

For the perfection of the security transfer agreement no notification to third parties is required and the transferred assets need not be handed over to the transferee. However, due to the requirements set out in Section 930 German Civil Code (BGB) a perfection of the security transfer agreement nevertheless requires the transferor to undertake that he will hold all present and future assets, which are or will be located in the designated security area, in the name and for the account of the transferee (Besitzmittlungsverhältnis).

### 6.2.1.6 Land Charge/Mortgage

There are two methods of taking security over real estate in Germany:

- (i) the mortgage (*Hypothek*), which is an accessory right; and
- (ii) the land charge (*Grundschild*), which is a non-accessory right.

As the land charge is independent of the primary payment obligation, the parties enter into a separate security purpose agreement describing the secured obligations and the trigger events that entitle the secured creditor to enforce the land charge. Both security rights require registration in the land register (*Grundbuch*) of the relevant local court (*Amtsgericht*).

It is market practice in banking transactions in Germany to take land charges; mortgages are used only very rarely.

Any land charge created after 19 August 2008 as security for payment obligations will need to be terminated by the land charge creditor in order for the land charge amount to become due and payable and therefore enforceable. The required notice period is six months. The land charge amount therefore falls due on the expiry of six months after the termination has been declared.

The land charge is only legal, valid and enforceable once the registration has been completed and, in the case of a certificated land charge (*Briefgrundschuld*), the land registry has issued a certificate. For registration purposes, the signatures to the agreement need to be publicly certified (*öffentlich beglaubigt*). Customarily, the agreement is combined with an abstract acknowledgement of debt (*abstraktes Schuldanerkenntnis*) of the debtor and submission to immediate enforcement (*Unterwerfung unter die sofortige Zwangsvollstreckung*). This enables the bank, in an enforcement scenario, to seize the debtor's assets without much delay and to enter into discussions or legal proceedings regarding potential defenses of the debtor mainly after seizure. The submission to immediate enforcement needs to be notarized (*beurkundet*).

### 6.2.2 Personal Security

Within the personal security - same as in relation to asset security - one differentiates between accessory and non-accessory security. In Germany the suretyship and the guarantee are the most common forms personal security.

#### 6.2.2.1 Suretyship

In a suretyship the surety undertakes to assume responsibility for the obligation(s) of a borrower, if that borrower defaults. Due to its accessoriness (*Akzesessorietät*), the suretyship is used very rarely to secure third party's obligations in Germany.

### 6.2.2.2 Guarantee

In contrast to a suretyship, a guarantee in general is non-accessory, and, hence, independent, of the main debt.

By giving a guarantee, the guarantor guarantees to a creditor the proper and punctual observance and performance of obligations of the debtor. Furthermore, the guarantor usually agrees to assume responsibility up to a certain amount and to pay that amount under certain circumstances to the lender upon prior written demand, if the obligor failed to pay the secured obligations. Due to the fact that the liability of the guarantor can be limited in the guarantee and that it is a non-accessory security, the guarantee is used more often than a suretyship to secure redemption claims.

### 6.2.3 Financial Assistance and Capital Maintenance

As a general rule, (under section 71a (1) sentence 1 of the German Stock Corporation Act (*Aktiengesetz, AktG*)), German law does not allow a stock corporation (*Aktiengesellschaft, AG*) to provide financial assistance to a third party for the acquisition of the stock corporation's own shares. The prohibition does not apply, however, to a GmbH. Financial assistance is therefore generally permitted for limited liability companies, unless the act of financial assistance violates capital contributions and maintenance provisions. These capital contributions and maintenance provisions contain extensive limitations and can lead to the same effect as the prohibition in section 71a (1) sentence 1 of the Stock Corporation Act.

Under German law, granting security in favor of shareholders and affiliated companies (other than subsidiaries, i.e. a company granting security over its assets for debt incurred by its shareholder or affiliated companies ("**Up-/Cross-stream Security**"), might - if such security is enforced - be deemed a prohibited repayment of the registered share capital to the shareholders and/or might endanger the corporate existence of the company granting the security.

Capital Maintenance

Pursuant to Section 30 German Act on Limited Liability Companies (*GmbHG*) a German limited liability company (or in case of a GmbH & Co. KG, its general

partner) may not pay out to its shareholders any funds which are required to maintain the GmbH's registered share capital.

In general, any direct payment to the shareholder which affects the registered share capital is prohibited. In addition, all kind of other distributions from which the shareholder benefits directly or indirectly, e.g. if the company grants security over its assets for debt incurred by its shareholder or affiliated companies, might violate the restrictions set out in Section 30 GmbHG.

If a creditor enforces such Up-/Cross-stream Security to satisfy its claims against the shareholders, this qualifies as a payment of funds to the shareholder for the purposes of Section 30 GmbHG. The limitations arising from Section 30 GmbHG apply vis-à-vis the shareholder only and do not restrict the secured party to enforce the security. As a consequence, the respective secured party can enforce the security in breach of Section 30 GmbHG and the shareholders, as well as the managing directors of the company, may become liable to reimburse the amounts equivalent to the amounts required for the preservation of the registered share capital (Sections 31, 43 GmbHG).

#### 6.2.3.1 Corporate Existence

The management of the German company and the borrower might be held personally and/or, in very rare cases, criminally liable. According to Section 64 GmbHG, managing directors of a GmbH might be liable for all losses and damages the company suffers itself, if their dispositions or actions led to the insolvency and if not having acted with the diligence of a prudent business man. The essential element is the drawing of liquidity from the German company. According to relevant literature, the granting of Up-/Cross-stream Security has to be treated as a payment in the sense of Section 64 sentence 3 GmbHG. In addition, payments to a direct or indirect shareholder by way of Up-/Cross-stream Security may conflict with the rules and principles of an action threatening the corporate existence (actions causing insolvency), i.e. the prohibition to transfer assets to a shareholder, if such transfer could deprive the German limited liability company of its ability to meet its obligations towards other creditors when due (Section 43 (3) GmbHG and Section 826 German Civil Code, BGB). Any disposition of the shareholder (i) has to consider the interest of the company to be able to fulfill at all times its other obligations as and when they

become due and (ii) may not jeopardize the existence of the company (*existenzgefährdender Eingriff*).

### 6.2.3.2 Limitation Language

In order to avoid such liability of the shareholders or the management of a GmbH, the enforcement of any Up-/Cross-stream Security is generally subject to certain restrictions. The respective provisions in finance documents (such term to include the loan documentation, any guarantee and any security document) are referred to as limitation language, which effectively prevents the secured parties to enforce the security in certain events which would trigger such liability, i.e. an enforcement is generally only permitted into the net assets of the company, i.e. the company's assets, deducting liabilities and the registered share capital. From a beneficiary's perspective, this limits the value of any security obtained, but is market standard.

### 6.2.4 Cash Pooling

The management of a company incorporated in Germany as a GmbH which participates in a cash pool (other than as cash pool leader), must be able to withdraw from that cash pool upon the occurrence of certain circumstances in order to comply with its capital maintenance requirements at any time.

In order to assess the financial situation of the cash pool leader (or its parent company, depending on the structure of the cash pool) or the other cash pool participants, the German company must have full access to the cash pool leader's and the other cash pool participants' financial information.

Any indemnity or guarantee, if any, needs to be limited.

Recent judgements of the German Federal Court (civil as well as criminal law cases) have imposed certain restrictions on (zero balance) cash-pool systems applied within groups of companies consisting of, inter alia, German limited liability companies. A similar problem arises in relation to guarantees and/or indemnities to be given by any German company participating in the cash pool in favour of the bank providing for the respective services, if such guarantee/indemnity is actually enforced. Both, up-stream loans and up-stream security

are likely to violate German capital maintenance provisions, provided that the relevant amount of the loan or the proceeds from the enforcement of any guarantee/indemnity exceed (in their aggregate) the amount of capital reserves plus profit carry-forwards of the relevant German company. German law permits payments of a limited liability company to its shareholders, if the corresponding repayment claims are of full value (*voll werthaltig*) and enforceable (*durchsetzbar*). Technically a fully-valuable and enforceable repayment claim can be included in the calculation for deciding whether a deficit balance occurs. The management of the German Company has the obligation to verify the repayment claim's full value and enforceability at the date of the payment. Furthermore, it has to monitor the claim's full value and enforceability, since a reduction of same would change the basis for the calculation of a deficit balance and therefore have a direct effect on the question whether capital maintenance provisions have been violated. Practically, the management of the German company has to constantly monitor the economic situation of its shareholders, the parent and the group as a whole. If a deficit balance occurs because payments are made or repayment claims are not enforced, the members of the management of the German company as well as of the parent might be held personally and/or, in very rare cases, criminally liable.

In addition, to the extent that participating in a cash pool endangers the existence of the German company, such participation is prohibited (not irrespective of the amounts credited to cash pools are to be deemed as repayment of registered share capital or not). From a practical perspective, such scenario might be triggered if e.g. the participation in the cash pool causes an illiquidity of the German company (e.g. due to insolvency of the Parent or non-repayment of the credit amount to the relevant German company). Payments which cause an illiquidity of the German company might trigger a personal liability of the management.

Finally, an insolvency of the German company might affect the validity of the set-off of upstream against downstream loans in the netting process of the cash pool system. As a result, there is a certain risk that the insolvency of the German company will trigger repayment claims of the German company against its shareholders.



# Doing Business in Germany



# Typically German



*The **Pickelhaube** (from the old German *Pickel* = "point" or "pickaxe", and *Haube* = "bonnet", a general word for headgear) was a spiked helmet worn in the 19<sup>th</sup> and 20<sup>th</sup> centuries by German military, firefighters, and police. Although stereotypically associated with the Prussian army, the helmet enjoyed wide use among uniformed occupations in the Western world.\**

\* Texts taken from publicly available sources (Internet etc.)

## 7 EMPLOYMENT

At the heart of every undertaking lies the essential power source of human capital. In order to maximise the potential of the German workforce, it is necessary to be familiar with its unalienable rights, which are incorporated in a set of rules dating back to the labor movement of the early 20th century. Employees, their representatives and unions expect both long-standing and new employers to respect their deep-rooted rights – in return, employers in Germany experience very stable employment and industrial relationships.

Traditionally, the legal framework consists of three levels: (i) the individual employment relationship; (ii) information, consultation and co-determination rights of employee representative bodies; and (iii) collective bargaining agreements between companies, associations and unions.

### 7.1 Terms of Employment

In a typical German employment relationship, the parties agree all material terms and conditions of employment in a written contract. Verbal agreements, even though permitted by law, should be avoided, as they are a regular source for disputes. Employment contracts must consider any existing collective regulations, such as works council agreements and collective bargaining agreements, and they should also address company policies. It is very common for flexible remuneration components, such as bonus, commission, equity rights or occupational pensions, to be dealt with separately.

Employment contracts qualify as general terms and conditions under German law: they must be clear, transparent and must not unreasonably disadvantage the employee.

*To avoid the argument of ignorance or misunderstanding, employment contracts should be in writing and in the German language. In practice, foreign investors often adopt a bilingual version of their employment contracts.*

## 7.2 Working Conditions in Germany

There is detailed legislation in Germany on working conditions. In numerous cases, the law sets forth mandatory provisions, which employers cannot opt out of.

### 7.2.1 Fixed-Term Employment

When it comes to considering the term of employment, from a commercial perspective, flexibility is the main criterion. Employment contracts in Germany may have a limited term, if the employer states a valid reason for the specific time limitation. Such reason may be a probationary period, reasons related to the individual employee (e.g. a time-limited work permit, education as prevailing purpose of the employment relationship, etc.), or a limited need for the services. In the absence of a valid reason for such time limitation, fixed-term employment contracts can be entered into for up to two years. Within the two year period, the contract can be renewed up to three times, although the total period of employment must not exceed the overall limit of two years. Furthermore, a fixed-term contract cannot be entered into if it was preceded by any kind of employment between the same parties within the last three years prior to the effective start date of the new fixed-term contract. Employers who fail to observe the prerequisites will have to tolerate the contract being deemed indefinite.

*Up-side for new investors: if a new company is established (other than in the context of a restructuring) a fixed-term employment agreement may provide for a maximum term of four years.*

### 7.2.2 Part-Time Employment

In Germany, all employees including managerial employees can request to work part-time, provided they have been employed for more than six months, and provided that their employer employs more than 15 employees (for part-time work during parental leave please see Section 7.2.14). The request must be made at least three months in advance. An employee's request to work part-time can only be refused for valid business reasons. Such reasons are given, for example, if the part-time arrangement negatively affects the organization, the operative structures or the security of the employer's plant, or if it would lead to unreasonable costs.

The details of the part-time arrangement must be agreed between the employee and the employer. The employer must accept the employee's wishes regarding the number and distribution of the working hours, unless this would not be feasible for business reasons.

Should an employer refuse an employee's request for a part-time arrangement or proposal for a specific distribution of the working hours, the employer must notify the employee one month prior to the requested commencement of the proposed part-time arrangement. In the event the employer does not observe the one-month period, the working hours / hours distribution of the employee will be reduced automatically as requested.

### 7.2.3 Working Hours

German legislation provides for a regular working day of a maximum of eight hours. Employers may extend the daily working time to 10 hours if, within a six-month period, the average daily working time does not exceed eight hours. Collective bargaining agreements may provide for extensions. The aforementioned maximum hours include overtime work.

*Further extensions of the working hours are permissible, subject to the approval of the competent supervisory authority.*

### 7.2.4 Base Salary

It is very common in Germany for employment contracts to provide for a certain sum to be paid as base salary.

As of January 1, 2015, a minimum wage of EUR 8.50 per hour applies to all employees in Germany. Principally, each employee over the age of 18 years working in Germany shall receive this minimum wage, regardless of the working time and its scope. Exceptions apply under specific conditions to interns and long-term unemployed persons. Additionally, the new Minimum Wage Act provides for a step-by-step introduction of the minimum wage in the newspaper delivery sector. In the introduction phase until December 31, 2017, deviations by collective bargaining agreements are permissible. Parties to a collective

bargaining agreement, however, are free to establish other minimum standards, and some have done so. If the employment contract is subject to a collective bargaining agreement, the salary must not be lower than the amount specified in the relevant collective bargaining agreement. A number of collective bargaining agreements are generally applicable for companies of a certain industry sector in certain regions. Any company doing business in Germany needs to review this situation carefully to assess whether or not such collective minimum standards apply.

### 7.2.5 Christmas and Vacation Payment

In Germany, it is common to pay an additional full or partial salary payment during vacation time in summer and before Christmas. A pro rata payment can be agreed on if the employment commences or ends during a calendar year.

### 7.2.6 Bonus

Many employers agree that a part of the remuneration package will be flexible. The flexible component is typically based on a bonus scheme and related to the achievement of financial and individual targets. Such bonus schemes are subject to judicial review under complex legal rules and should therefore be considered carefully. Bonus payments at the company's unconfined discretion are generally not allowed.

### 7.2.7 Overtime Pay

Under statute, the payment of overtime is not mandatory. However, numerous collective bargaining agreements provide for overtime compensation of 25% or more above the normal salary.

Contractual clauses stipulating that the base salary shall compensate the employees for any and all overtime work are likely to be held invalid, should they be contested in court: under German law, such clauses must specify the actual number of overtime hours being compensated by the base salary, and the amount of such overtime work should not exceed 20% of the regular working time agreed for the same period of time. Any additional overtime work would need to be compensated either by time off in lieu or additional remuneration.

### 7.2.8 Commission

Some employees receive a substantial part of their remuneration in the form of commission. Commission is the typical remuneration of self-employed sales representatives and it is also very common for employed sales agents. The commission payable will normally be calculated as a certain percentage of the turnover generated by the employee.

Employees who qualify as sales agents under the German Commercial Code are entitled to commission for sales contracts concluded as a result of their promotional efforts. However, should the third party not fulfill the sales contract, no commission can be claimed.

The employment contract can also provide for commission to be paid for all sales generated within a certain sales territory, not necessarily resulting from the promotional efforts of the employee himself, but also from those of his or her fellow employees working in the territory.

As a general rule, commission will only be due in relation to those sales contracts concluded during the term of the employment contract. If a sales contract is concluded after employment terminates, the employee will, nevertheless, be entitled to the commission, provided that the sales contract was due mainly to his or her promotional efforts.

### 7.2.9 Company Car / Car Allowance

A company car can be granted for professional use only. In most cases, however, the employee is also entitled to use the company car for private purposes. This is a taxable monetary benefit, but it enjoys favourable treatment under German income tax law. Alternatively, a company could pay a car allowance on top of salary. Having said that, a company car is a highly valued benefit and rather common for senior employees or those who have to travel extensively.

*From an employee's perspective, being provided with a company car is more tax efficient compared to receiving a car allowance from the company, since the latter will be treated as fully taxable income.*

### 7.2.10 Reimbursement of Expenses

An employer must reimburse its employees for any expenses which could reasonably be considered as necessary in performing their working duties. Reimbursement of expenses is not part of the employee's remuneration, but is an independent legal claim which can be invoked even if not mentioned in the employment contract.

*Unless the parties agree on a fixed lump sum to cover all reimbursable expenses during a specified time period, the employment agreement should specify the formal reimbursement conditions.*

### 7.2.11 Public Holidays

On Sundays and public holidays, work is usually not permitted, although there are certain statutory exceptions. If an employee works unlawfully on Sundays or legal holidays, the manager who is responsible may be subject to fines.

### 7.2.12 Paid Annual Leave

Employees are entitled to annual leave of at least 20 working days based on a five-day working week (minimum period of four weeks per year) regardless of daily working hours. An employee is entitled to take his or her first period of leave after the first six months of employment. As a general rule, the employee may then claim his or her full annual vacation allowance without regard to the date on which his or her employment started or will be terminated. On the other hand, if the employment relationship ends prior to or at the expiry of the six-month waiting period, the employee is entitled to the annual leave accrued on a pro rata basis, as soon as the employment relationship ceases (e.g. if a fixed term of not more than six months is agreed in advance or the contract is terminated either unilaterally or by mutual agreement).

*Most employers offer between 25 and 30 days of paid annual leave.*

### 7.2.13 Sick Pay

An employee who is unable to work due to sickness will receive sick pay from the employer, unless he or she has been employed for less than four weeks or where the sickness in question has been caused by the employee him or herself. Fault in this case is limited to intentionally or gross negligently causing the sickness. German statute provides that, where an employee is sick, 100% of the employee's regular salary will be paid for a maximum period of six weeks. The employment contract may provide for a longer period.

Once the employer's liability to pay sick pay ceases, public health insurance becomes responsible for a reduced level of sick pay to employees who are enrolled in the public health insurance scheme.

### 7.2.14 Maternity Protection Leave and Parental Leave

Pregnant employees enjoy special protection against termination. Furthermore, they are prohibited from working within the last six weeks of pregnancy and within eight weeks afterwards. During this protection period, the mother's salary is partly paid by the government.

After maternity leave, either parent is entitled to special leave called "parental leave". Parental leave can be taken for up to 36 months until the child has reached the age of three. It may be taken in several periods by either parent or combined by both parents. With the consent of the employer, a maximum period of 12 months can be taken as parental leave until the child has reached the age of eight. During parental leave, the employee can also request a part-time arrangement between 15 and 30 hours per week for a minimum period of two months. During parental leave, employment can only be terminated upon prior approval by the competent authorities. The employee can apply for specific parental allowance paid by the government.



### 7.2.15 Confidentiality and Restraints against Competition

The employee's duty of confidentiality is part of the general duty of loyalty owed to the employer. This duty covers all of the firm's business secrets, such as technical know-how, customer and supplier lists, prices; however, public knowledge cannot constitute a business secret.

During employment, the employee is prohibited from working for a competitor, and from soliciting customers, suppliers or employees. Post-employment, the employee is generally free to compete and solicit customers and employees, if not bound by a post-contractual non-compete and non-solicitation covenant. Such covenants are subject to compensation payments to the employee.

*In addition to employment law, solicitation is also subject to mandatory unfair competition law to the extent that acts of solicitation may be prohibited.*

### 7.2.16 Suspension from Work; Garden Leave

In principle, a German employee has a right to work. In case of termination, however, and provided it has been previously contractually agreed, the employee can be suspended from his working duties during the notice period.

## 7.3 Equal Treatment and Discrimination

German employees enjoy enhanced equal treatment and discrimination protection. In order to comply with the obligation to transpose certain European Commission Directives into German law, Germany recently implemented the principle of equal treatment in the form of a separate code, called the General Equal Treatment Act (*Allgemeines Gleichbehandlungsgesetz – AGG*). Pursuant to this Act, an employer is obliged not to discriminate against employees on grounds of race or ethnic origin, gender, religion or secular belief, disability, age or sexual identity. In particular, the General Equal Treatment Act prohibits discrimination in relation to recruitment, promotion, remuneration and dismissals. The Act only allows for limited exceptions to the principle of equal treatment where there are "justifying reasons". Discrimination may only be justified if the employer can refer to one of the justifying reasons specified by the General Equal Treatment Act (e.g. if the relevant characteristic is indispensable for the work to be performed).

According to the General Equal Treatment Act, any harassment is regarded as discrimination. There are no justifications for any such conduct.

Where discrimination occurs, the affected employee can claim compensation for material or non-material losses from the employer or directly from the person who caused the damage. He or she can also file a complaint with the responsible body in the workplace. The employer must therefore take anti-discrimination measures. The amount of damages employees can claim will be assessed by the labor courts, as the Act itself only refers to the right to demand "appropriate monetary compensation".

Clauses in agreements which breach the Act are invalid. In recruitment scenarios (job postings, interviews, etc.), the breach itself does not give rise to a claim regarding the formation of the employment relationship, but the employer will be obliged to compensate the candidate being recruited for any losses incurred as a consequence of the breach. Non-monetary damages for discrimination in the hiring process are limited to a maximum monetary compensation of three months' salary, even if the candidate would not have been hired had the selection process been free of adverse treatment.

The employer is under an obligation to protect employees and to take pre-emptive action against discrimination. According to the Act, the employer is required to give special training to employees in order to raise awareness in the company that discrimination must be avoided. To this end, the text of the Act and special regulations concerning the procedure of a discrimination claim before the labor courts, as well as the competent person in the operation to deal with discrimination complaints, must be published within each business unit. This information may be provided through the intranet.

*German insurers have adapted to the demand arising from the legal position and are offering risk policies for "Employment Practices Liability".*

To a limited extent, German anti-discrimination laws provide for equal payment: unequal payment must not be based on grounds of ethnic origin, gender, religion, disability or age. This certainly does not prevent the employer from justifying unequal treatment with other grounds.

## 7.4 Integration of Disabled Employees

Under German law, disabled employees have extensive rights to ensure their integration into the working environment and to diminish indirect discrimination.

Social security laws impose a legal obligation on any employer to determine if there are job vacancies that could be filled by disabled employees (e.g. by checking with the local job office). This obligation is matched by a requirement for companies with 20 or more employees to ensure that at least 5% of their overall workforce comprises severely disabled employees. For every job position an employer falls short of its quota, it must pay an equalization levy of between EUR 115 and EUR 290 per month, depending on the company's size and the number of disabled employees.

Disabled employees working in business entities with five or more severely disabled employees may elect a representative body which cooperates with the company's works council and must be informed and heard by the employer on all measures concerning disabled employees.

## 7.5 Termination of Employment

Although used as a last resort, business circumstances may force an employer to unilaterally terminate one or more employment contracts. Obviously, an employment contract may be terminated by mutual agreement between an employer and an employee. Such a separation agreement must be in writing. It is not subject to the manifold restrictions which have to be considered in the event of unilateral termination by the employer.

*Financial downside of a separation agreement: the local Employment Office may impose a blocking period on the employee, who will then not receive unemployment benefits for up to three months.*

An employment contract can be unilaterally terminated by either party by giving notice of termination. Whereas an employer who terminates an employment contract is subject to numerous statutory restrictions, an employee only needs to observe applicable notice periods. The basic statutory notice period is currently four weeks to the 15<sup>th</sup> or to the end of a calendar month. Depending on the

employee's seniority, the notice period to be adhered to by the employer increases up to a maximum of seven months to the end of a calendar month after twenty years of service. Unless otherwise agreed, the extended notice periods do not apply to the employee.

During a probationary period, which may not exceed the first six months of employment, the notice period is two weeks, unless the contract provides for a different notice period during probation. During probation, no specific reason is required for the termination to be effective.

In certain cases, no notice period will need to be observed at all. This is the case where there is an "important reason" for the extraordinary termination. Such termination may take immediate effect. An "important reason" exists when there are grounds on which the terminating party cannot reasonably be expected to continue the employment. If contested in court, all circumstances of the individual case will be taken into consideration.

### 7.5.1 Protection against Termination

German law on termination protection is principally governed by the Termination Protection Act (*Kündigungsschutzgesetz – KSchG*). Employees who work in a business unit which regularly employs more than 10 employees and who have more than six months' consecutive service are eligible for termination protection.

Termination protection is a contentious issue between the political parties in Germany, and therefore subject to regular legislative changes: until December 31, 2003, a business unit consisting of more than five employees qualified for termination protection. Employees who worked in a business unit of more than five employees prior to January 1, 2004 have not, however, lost their termination protection as a result of the legislative changes.

Once eligible for termination protection, the employer can terminate the employment contract with the employee only if the termination is justified by specific reasons. The reasons for the termination must be based on the person, on his or her conduct, or on compelling business requirements.

### 7.5.2 Reasons Based on the Employee's Person

Personal qualities of the employee, e.g. his or her physical or mental inability, can justify the termination. The most common reason for a termination under this category is a termination due to lengthy or frequent illness.

### 7.5.3 Reasons Based on the Employee's Conduct

Severe misconduct on the employee's part will often justify a termination without notice. Less serious cases of misconduct will allow only a termination with ordinary notice. "Misconduct" is the breach of any obligation which the employee owes to his or her employer.

*A single case of misconduct will often not be sufficient to justify a termination: German courts usually require that the employee be formally warned not to repeat his or her misconduct. For evidential purposes, a formal warning should be made in writing.*

### 7.5.4 Compelling Business Requirements

Termination of employment becomes often necessary to meet business needs: for example, the introduction of new technology, changes in production methods, the shutting down of a plant, reduced sales, etc. will generally make dismissals inevitable. An employer is free to make economic plans and decisions, and the labor courts allow employers a certain degree of flexibility. Employers will be required by the courts, however, to explain and prove the facts on which the business decision is based.

If business considerations require the dismissal of an employee from a certain group, the termination may still be invalid if, amongst several employees whose contracts could also have been terminated, the employer did not make an appropriate choice from a social perspective. The employer will have to select for redundancy that employee who, from a group of comparable employees, is least severely affected by the termination. The following "social" criteria can be relevant: duration of service, age, maintenance obligations toward dependents and disability.

The employer may exclude from social selection those employees whose continued employment is in the legitimate interests of the company, due to their knowledge, skills, and performance or for the maintenance of a balanced personnel structure in the company.

### 7.5.5 Special Termination Protection

Employers cannot terminate the employment of a pregnant woman during pregnancy and up to four months after the birth without prior approval from the applicable authorities. During parental leave, this protection is extended until the end of the leave period.

An employer may terminate the employment of a disabled person only upon prior approval from the applicable authorities.

Members of the works council or similar representative bodies are subject to special termination protection; these employees can only be terminated for important reasons. Even a termination for an important reason can be put into effect only with the works council's consent.

*As an exception, if the firm is shutting down its business, the employment of a member of the works council may be terminated without an important reason with ordinary notice. If only a division is shut down, the employment of a works council member may be terminated only if the affected person cannot be transferred to another division.*

### 7.5.6 Mass Dismissals

Before an employer can give notice to numerous employees at the same time, the intention to do so must be discussed with the works council. In addition, the employer must inform the local Employment Office.

Terminations are considered to be a mass dismissal if they are effected within a 30 day period and include:

- More than five employees in a business unit with more than 20 and fewer than 60 employees; or
- 10% of the workforce, or more than 25 employees in a business unit with at least 60 and fewer than 500 employees; or
- 30 or more employees in a business unit with at least 500 employees.

### 7.5.7 Works Council Participation

In all business units represented by a works council, it is necessary to notify the works council in advance of an intended termination, be it an ordinary termination with notice or a for-cause termination with immediate effect.

The employer must notify the works council of all relevant reasons for termination in each specific case. If contested in court, an employer will not be able to justify the termination by stating reasons not revealed to the works council before notice was served. The employer can notify the works council verbally, but, for evidential purposes, such notification should be in writing.

Once notified of a contemplated ordinary termination, the works council must consent or object to the termination within a period of one week. When notified of an extraordinary termination, the period for the works council to react is three days after the notification. If the works council does not react to the intended termination within such period, its consent to the contemplated termination is deemed to be granted.

The notice of termination will not take effect if it is issued without prior notification to the works council or before the applicable reaction period has lapsed. On the other hand, the fact that the works council objects to an anticipated termination does not prevent the employer from serving notice. If the employee challenges the validity of the termination, however, the courts will take into consideration the works council's objections to the termination.

*Highly ranked managerial employees enjoy termination protection on a lower level only. Employers simply have to inform the works council reasonably in advance of an anticipated termination. Should this information not be given, the validity of the termination will not be affected.*

### 7.5.8 Termination Disputes

German employees are entitled to challenge the validity of a termination before the labor court, however, invalidity can be invoked only if a lawsuit is filed within three weeks from the time the original notice of termination was served.

Approximately one month after the lawsuit for unfair dismissal has been filed, a first conciliatory court hearing will take place to attempt to settle the dispute by mutual agreement.

*A settlement is usually concluded on the basis of a severance payment by the employer in exchange for the employee accepting the termination.*

If no agreement is reached in the conciliatory hearing, one or more additional court hearings will be held before the court finally renders its judgment. If the termination is held to be valid, the lawsuit will be dismissed. Otherwise, the employer will be liable to reinstate the employee. If, as is usually the case given the length of the complete court proceedings, the effective termination date has already passed at the time the judgment is rendered, the employer will also be held liable to pay outstanding salary.

### 7.6 Employee Representation

Employee representation in German operations plays a critical role amongst the various checks and balances which serve to protect employees' rights.



### 7.6.1 Works Councils

The establishment of a works council requires a business unit with at least five permanent employees.

*There is no legal obligation, either on the employer's part or on the employees' part, to set up a works council.*

Statute places an obligation on the employer to refrain from any action that could impede or interfere with the election and set-up of a works council.

Minimum requirements relating to employee representation do not supersede the constitutional right of entrepreneurial freedom. Fundamental business decisions will always be reserved for the employer, who has control over the property and facilities and the right to decide who may enter the premises.

Even though employer and works council may, from time to time, desist from this obligation, under normal circumstances they are required to meet at least monthly to discuss any problems that may have arisen, with the objective of reaching mutually acceptable solutions. Employer and works council must neither obstruct each other in the performance of their duties nor disturb the operations or peace in the workplace. Labor disputes (strikes, etc.) are not permitted at the works council level. Works council members must keep confidential any confidential information they receive from the employer.

The works council's participation in the decision-making process can be summarized as follows:

- Information rights;
- Consultation and co-operation rights;
- Rights of veto and rights of consent; and
- Co-determination rights.

Rights of veto are of particular importance in personnel matters, and exist in connection with the hiring of personnel, the classification and reclassification of employees into job categories and grades, and transfers of employees to other positions. In addition, the dismissal of members of employee representative bodies on a local or company level (if permissible at all) requires the consent of the works council. Rights of veto may also be exercised by the works council to block management decisions.

Co-determination rights require management to reach agreement with the works council on certain matters. If management and works council fail to agree, the conciliation board will be called upon to decide. In matters subject to co-determination by the works council, management cannot make or enforce any decisions without the work council's consent or a favorable decision of the conciliation board.

One of the most important areas in respect of the co-determination rights of the works council is in dealing with social matters. Social matters cover (inter alia): plant regulations and behavior of employees; work hours; terms of payment of remuneration; vacation; installation of most software programs; monitoring devices; safety and health; social facilities; employer-owned homes; wages and salaries; pension plans; systems for operational suggestions; and promotion of investment by employees.

In business units where more than 20 persons are employed, the works council enjoys co-determination rights in the event of operational changes. Before carrying out an operational change, the employer must attempt to obtain the works council's consent. If the change involves material hardship for a substantial number of employees, the employer must discuss and negotiate with the works council, explain the reasons that require the change of operation, listen to comments or suggestions put forward by the works council and try to conclude a "conciliation of interest agreement" with the works council. However, neither the works council nor the conciliation board has the power to force an agreement upon the employer.

If the employer does not agree to alternative solutions suggested by the works council or the conciliation board, it may proceed with an operational change as

planned. However, the works council does have the power to obtain from the employer (through a final and binding decision of the conciliation board) a compensation and benefits package designed to alleviate possible or actual hardship to the work force resulting from such operational change. This package is called a "social plan". Common features are: commuting allowances; rehabilitation subsidies; incentive payments; transfer of accrued pension rights; payment of the difference between unemployment benefits under the government plan and the regular net income; and, most important of all, severance payments to dismissed personnel.

### 7.6.2 Other Employee Representation

In addition to their representation by the works council, employees may be also represented by trade unions and through employee representation in the supervisory board of a company. Every investor setting up a legal entity in Germany needs to consider whether or not to become a member of an employers' association with the consequence of being subject to the collective bargaining agreements within the industry. This decision depends on the employment conditions that shall be put in place, the industry sector, the size of the business, and the harmonization of employment conditions.

*A trade union represents employees of a whole industry.*

In contrast, the works council is the elected representative of the employees of a specific business unit with the duty to represent the rights and interests of the employees of that business unit only. Although many works council members are also members of a union, there is not necessarily a link between the union and the works council. Works councils must perform their duties independently from trade unions. If there are disputes with the employer, the works council is often assisted by the trade unions although they are not obliged to render such assistance.

Under certain conditions, the employees of a company are entitled to be represented on the supervisory board of the company. Some companies have supervisory boards as they are required by law (e.g. a stock corporation), while other legal entities, under certain conditions, may have to install a supervisory board for the purpose of employee representation (e.g. a limited liability company).

Where a company has more than 500 employees, one third of the seats on its supervisory board must be reserved for employee representatives. Such representatives are to be elected by the employees of the company.

Where a company has more than 2,000 employees, on average half of the seats on its supervisory board are reserved for representatives of the employees. The representatives are elected directly or indirectly through delegates of the employees. Some of the employee representatives will be required to represent a labor union.

*Although the numbers of the employee representatives and the shareholder representatives in the supervisory board are equal, eventually the chairman of the supervisory board will be a shareholder representative having two votes. Therefore, the shareholders still retain a majority on the supervisory board.*

## **7.7 Collective Bargaining Agreements**

Trade unions in Germany conclude collective bargaining agreements with the employers' associations or with individual employers. These collective bargaining agreements are the regulatory instruments for remuneration, working conditions, work safety and similar matters. In a company's day-to-day business, the employer does not deal with the trade union's representative, but rather with its own works council.

Collective bargaining agreements are binding only upon the parties or the members of the parties who entered into the agreement. In principle, no collective bargaining agreement is applicable if the employer neither entered into such an agreement itself nor is a member of the respective employers' association.

Within certain industries, however, the Federal Minister for Labor and Welfare has decreed that collective bargaining agreements are generally binding. As a result, all employers or employees will be bound if they fall within the scope of the agreement.

## 7.8 Social Security

The German social security system includes different types of insurance, which to a certain extent, are mandatory.

### 7.8.1 Accident Insurance

Every employer has to insure its employees against work accidents. Statutory accident insurance is organized through employers' liability insurance associations that are industry / business specific. These associations individually fix the amount of contributions to be made by the employers.

### 7.8.2 Statutory Old Age Pension Insurance and Unemployment Insurance

In principle, enrolment in both the public old age pension insurance and the unemployment insurance scheme is mandatory for employees. Contributions to both types of insurance are computed on the basis of the employee's accountable income. The exact amounts of contributions and accountable income are reviewed annually by the Federal Parliament. Accountable income comprises not only cash payments but also those benefits which form part of the remuneration package and which are thus subject to regular income tax.

Contributions to the statutory old age pension system currently amount to 18.7% of the employee's accountable income. Contributions to the unemployment insurance system currently amount to 3.0% of the employee's accountable income.

In West Germany, accountable income for both types of insurance is presently the employee's salary up to a maximum of EUR 6,050 per month / EUR 72,600 per year. In East Germany, accountable income is EUR 5,200 per month / EUR 62,400 per year for the statutory old age pension system and for state unemployment insurance.

The above contributions are borne equally by the employer and the employee. The employer deducts the employee's portion from his or her gross salary and is liable for the transfer of the deducted amount to the competent institution.

### 7.8.3 Health Insurance and Nursing Care Insurance

In addition, there is mandatory health insurance and nursing care insurance in place.

Contributions to statutory health insurance currently amount to 14.60% of an employee's accountable income, equally borne by the employer and the employee. Contributions to the nursing care insurance scheme are borne equally by employer and employee and amount to 2.35% of accountable income (2.6% for employees aged 23 and older without dependent children).

For both health insurance and nursing care insurance, accountable income is currently the employee's salary up to a maximum of EUR 4,125.00 per month / EUR 49,500 per year.

Employees earning remuneration in excess of the accountable income threshold may opt for private health and nursing care insurance. Should they choose to do so, they will have to pay their insurance contributions in full out of their salary. However, they are entitled to a special allowance from their employer on top of their salary. This allowance is equal to the share that would have been payable by the employer if the employee was publicly insured, but not exceeding a monthly amount of EUR 288.75 for private health insurance and EUR 48.47 for private nursing care insurance.

## 7.9 Pensions

By law, all employees are in principle members of the public old age insurance scheme established and operated by the German government. In addition, many companies have voluntarily established an occupational pension plan for their employees. The most common type of scheme is a direct pension promise. The company will be obliged to set aside book reserves for pension liabilities arising from these pension promises. They can (but do not need to) be funded. If the company decides to fund pension liabilities, it normally does so by entering into reinsurance contracts or by building separate plan assets into a contractual trust arrangement (CTA). Other types of pension schemes are insurance based (direct life insurances, pension funds, mutual pension insurances) or "support funds", where a separate vehicle provides for the pension payments and is

financed by a sponsoring company. Pension schemes can be in the form of defined benefit plans or defined contribution plans. They generally provide for retirement, death and disability benefits either in the form of lump sum payments or in the form of annuities.

Pension entitlements generally vest after five years. However, if they are based on salary conversion, they vest immediately.

*German law provides that all employees can require their employer to convert a portion of their salary into contributions towards a private pension plan.*

Every three years, the employer must consider an adjustment in relation to pensions in payment, to reflect changing economic circumstances. This must take into account both the employees' interests and the company's economic strength.

In the event that a company becomes insolvent, a Pension Guarantee Association will make the relevant pension payments to employees. Contributions to this insolvency fund must be paid by all companies operating a pension scheme based on a direct pension commitment, support funds or pension funds. Insurance-based schemes are generally exempt from these contributions.

## **7.10 Immigration Requirements**

Any foreigner who intends to live and work in Germany requires a combined residence and work permit before he or she can commence employment. This permit is issued by the applicable Immigration Office upon approval of employment by the Employment Office. The latter approval will be obtained internally by the Immigration Office, and no separate application with the Employment Office is necessary.

Generally, the combined residence and work permit will be granted for a limited period of time only. Extensions should be applied for in due time if required.

Special rules apply to citizens of European Union member states as well as to citizens of countries belonging to the European Economic Area who are, in general, free to reside and work in Germany without performing any prior formalities. The only obligation is to register their local address with the competent Residence Office on arrival. According to treaties between Switzerland and the EU, Swiss nationals enjoy immigration rights equal to those of nationals from European Economic Area countries as well.

*For countries joining the European Union as a new member state, access to the European Union labor market is usually restricted for several years. However, currently this applies to Croatia only. Unless member states enjoy the privilege of free access to the European Union labor market, their citizens will need to apply for a national work permit with the local Employment Office.*

Non-European Union citizens must apply for a residence permit before entering Germany for any purpose. If the purpose is employment, they will have to apply for the combined residence and work permit. Such persons will need to obtain the permit as a visa from the respective German embassy. If the individual intends to take up employment in Germany, the embassy will consult with the Immigration Office as well as the Employment Office before a visa is issued.

Special visa rules apply to citizens of privileged countries such as Australia, Israel, Japan, Canada, the Republic of Korea, New Zealand and the United States. Citizens of these countries need not obtain a visa prior to entry into Germany but need to obtain the combined residence and work permit within three months following their arrival in Germany. Applications must be made with the competent local Immigration Office. Citizens from these countries must not take up employment prior to obtaining the combined residence and work permit.

If a visa is required, an application in the prescribed form must be prepared and submitted prior to entering Germany (at the German embassy or consulate that processes visas in or near the applicants city of residence). Application forms can be obtained from the German embassy or consulate. For those who intend



to work in Germany, the residence permit application must be accompanied by information regarding the intended employment and the intended place of residence in Germany (e.g. rental agreement). The embassy or consulate will issue the visa upon internal approval by the applicable Immigration Office and, if applicable, by the Employment Office. Such visa will contain both the residence permit and the authorization to work in Germany and is, in general, valid for a period of three months. On arrival, the foreign individual has to register his or her local address with the competent Residence Office and to make an appointment with the local Immigration Office which will then, in a next step, issue the national work-related residence permit to the individual.

*The initial work-related residence permit is usually granted for a fixed term only. In determining the length of this period, the authorities have a rather wide discretion. Normally, the initial residence title is given for a period of one or two years, with the option to renew the permit in due course.*

# Doing Business in Germany

# Typically German

*The Froschkönig or der eiserne Heinrich (Frog King or Iron Henry), also called The Frog Prince, is a fairy tale best known through the Brothers Grimms written version; traditionally it is the first story in their collection.\**

\* Texts taken from publicly available sources (Internet etc.)



## 8 COMMERCIAL

### 8.1 Freedom of Contract

Freedom of contract is a central element of German civil law. This general principle is supported by four pillars: First, as a general rule, no-one is under any obligation to enter into a contract. Second, the terms and conditions of the contract depend solely on the parties' agreement, subject to applicable mandatory law. The third pillar of the freedom of contract principle is that German civil law contains very few formal requirements. Finally, the parties are free to choose the law applicable to their contract. The principle of freedom of contract, however, does not apply without exceptions. It is therefore of vital importance to know and observe these exceptions in order to avoid costly pitfalls when operating a business in Germany. The most important restrictions are set out in the following paragraphs.

### 8.2 Direct Selling to Consumers

Particularly when contracting with consumers, various consumer protection laws must be observed. Many of these laws are based on European Commission Directives, and similar laws have therefore also been implemented by other members of the European Union.

#### 8.2.1 Definitions of the Terms Entrepreneur and Consumer

Business-to-Business contracts are entered into between entrepreneurs, whereas Business-to-Consumer contracts are entered into between an entrepreneur and a consumer. An entrepreneur is a natural or legal person who is entering into a contract as part of his or her trade or profession, whereas a consumer is a natural person who enters into a contract for a purpose outside of his or her trade or profession.

#### 8.2.2 Consumer Protection Laws

Consumers enjoy a high level of protection in Germany. To name the most important types of contract, where the seller has to comply with specific obligations: If a sales contract is concluded away from business premises or a

product is sold via distance selling (such as via the internet), the seller will be obliged to comply with certain requirements when concluding a contract with a consumer. Additional requirements apply to consumer credits. In general, the consumer will also have the right to withdraw such contracts within a certain time period without having to give any reasons (see Section 8.2.4).

*This high level of consumer protectionism is not unique to Germany and is generally imposed throughout the European Union.*

### 8.2.3 Information Requirements

Sellers concluding contracts from a distance, by way of letter, fax or the internet, are required to provide consumers with extensive information, some prior to, some after the conclusion of the contract. With respect to contracts that are entered into over the internet (E-commerce), additional requirements must be observed. Information to be provided includes: the identity and address of the seller; the main characteristics of the goods; the end price including all taxes and charges; payment and delivery terms; and details about the consumer's right to withdraw from the contract. Failure to comply with the information requirements does not necessarily have a direct effect on the validity of the sales contract. The seller's breach, however, may influence the consumer's right to withdraw and may trigger a claim for an injunction.

### 8.2.4 Withdrawal

Consumers are entitled to withdraw from consumer credit agreements, contracts negotiated away from business premises and contracts that are entered into from a distance. This right to withdraw is available regardless of the reason for the withdrawal or the condition of the goods. The withdrawal period is generally 14 days. When this period starts depends on the type of contract. Typically, it starts on the date of conclusion of the contract or with receipt of the goods by the consumer.

Failure to fully comply with this obligation to inform the consumer about the right to withdraw from the contract prolongs this right. In this case, the consumer's right to withdraw from the contract will expire at the latest 12 months and 14

days after the initial 14 days withdrawal period would have started. The information on the withdrawal right to be given by the seller is subject to detailed requirements and specific attention should be paid to both content and layout in order to comply with the relevant rules. The sample notification prescribed by law should be used.

*Commercial sellers should use a standard information package appended to all contracts that complies with the relevant information obligations owed to consumers.*

### 8.2.5 Inertia Selling

If a business renders unwarranted services or delivers goods to a customer that have not been requested by the customer (inertia selling), the customer will be under no obligation with respect to the services or goods. In particular, the customer's use of the services or goods does not constitute a tacit agreement or acceptance and no claim for payment arises from such conduct.

## 8.3 Standard Contracts and General Terms & Conditions

An agreement is a standard agreement if it is prepared for a multitude of contracts and presented to the other party for inclusion in the parties' agreement on a "take it or leave it" basis. In contrast, an agreement is an individual agreement if and to the extent its content has indeed been negotiated and agreed by the parties.

The purpose of the provisions of German law on standard terms and conditions is to protect the (presumably) weaker party to a contract. In order to ensure that one party cannot unilaterally prescribe the terms of the contract, German law very strictly limits the leeway available to the parties to deviate from applicable statutory provisions in standard clauses used by them. Essentially, German law declares void and unenforceable any standard contract clauses which constitute an unreasonable disadvantage to the other party or which are ambiguous, unclear or surprising. In practice, there is often little leeway to deviate from applicable statutory provisions, and there is often a fine line between valid and invalid wording.

These rules apply not only to Business-to-Consumer contracts but largely also to Business-to-Business contracts. If a significant part of a business depends on the use of standard contracts and / or general terms and conditions, it is essential to observe relevant statutory provisions as well as applicable case law, which has helped to establish and refine the requirements for standard clauses. If a company makes use of standard clauses that infringe German law on standard terms and conditions, such clauses will automatically be invalid and unenforceable, and the relevant statutory provisions will apply instead. There is also a risk that competitors or fair competition advocacy groups may bring legal action in the form of an application to restrict the further use of the invalid clauses. Losing such an action for injunction can be costly.

*Before starting business in Germany, all standard contracts as well as general terms and conditions that may already exist should be adapted in accordance with German requirements.*

## **8.4 Sales via Intermediaries**

As many companies distribute their products via intermediaries, the particularities of the various types of intermediaries should be taken into account prior to making a strategic decision on the structure of the distribution system.

### **8.4.1 Commercial Agents**

A commercial agent is a self-employed intermediary who has continuing authority to solicit business on behalf and for the account of a principal. Pursuant to a European Commission Directive, commercial agents enjoy certain mandatory rights. The two most important rights are the commercial agent's claim for termination indemnity and the statutory minimum notice period for ordinary termination.

### **8.4.2 Distributors**

A buy / sell distributor is a self-employed intermediary who buys certain products from its principal and sells them to third parties in its own name and for its own account. There is no statute governing buy / sell distributors in Germany.

However, according German case law, some of the provisions on commercial agents apply by analogy to distributors.

When contracting with buy / sell distributors, two aspects require particular attention: (i) buy / sell distributors may be entitled to claim an indemnity upon termination of their distribution agreement if certain requirements are met; and (ii) certain restrictions imposed upon the buy / sell distributor (e.g. with regard to the contractual territory or customers, pricing, etc.) trigger serious concerns under German and / or European Union competition law.

### 8.4.3 Commissionaires

A commissionaire is a self-employed intermediary who buys or sells certain products in its own name but for the account of a third party. A commissionaire is distinct from the other types of sales intermediaries insofar as it is not – at least not in the same manner – integrated into the sales organization of a principal. If a commissionaire has continuing authority to act for a specific third party, such commissionaire is qualified as a "commission agent" and – depending on the particularities of its rights and duties – the provisions on commercial agents may apply by analogy. Therefore, particular attention should be paid to the contractual duties imposed upon a commissionaire.

### 8.4.4 Franchising

German legislation does not contain any specific provisions on franchise agreements. The concept of franchising is understood as a contractual relationship of its own nature with elements of buy / sell distribution and licensing. The legal framework for franchising has, to a large extent, been shaped by case law. Particular care should be taken with regard to potential labor law implications and termination indemnity issues, as well as the numerous information requirements that the franchisor has to comply with.

*When determining the pros and cons of certain distribution structures and the issues related to these structures, logistics, tax and customs issues must also be taken into account.*



#### 8.4.5 Typical Issues

A common feature amongst all of the intermediaries outlined above is that they are self-employed, yet are commercially dependent on the principal. Typical issues to be addressed in the agreements with intermediaries therefore involve ensuring that there is adequate protection for the intermediaries. Termination indemnity and notice periods for termination are the most important issues.

#### 8.4.6 Termination Indemnity

A commercial agent will be entitled to an indemnity upon termination of the agency agreement, where certain conditions are met. Such termination indemnity may amount up to the average annual commission earned by the commercial agent during the last 5 contract years (or any shorter contract period) preceding termination. However, the actual sum of the termination indemnity will be determined by way of a complex calculation in each particular case and may also be (much) lower than the aforementioned average annual commission, which is only a cap.

The potential termination indemnity claim of the commercial agent is based on a European Commission Directive and is thus widely harmonized throughout the European Union. This claim cannot be limited or restricted by the parties before actual termination of the agency agreement and cannot be avoided by choosing not to have the contract governed by German law, unless the contract territory is located outside of the European Union and the European Economic Area.

Based on established case law, buy / sell distributors as well as franchisees and – potentially – commission agents are also entitled to claim a termination indemnity, provided that they are integrated into the sales organization of the principal in a manner comparable to a commercial agent. Therefore, the set-up of a distribution or franchise system particularly requires a deep knowledge and understanding of said case law in order to avoid unnecessary (payment) obligations of the principal upon termination.

## 8.4.7 Competition Law

German and / or European Union competition law plays an important role for the drafting of distribution and franchise agreements. Restrictions imposed upon distributors and / or franchisees (e.g. regarding the territory, customers or pricing of the contract) may therefore trigger serious competition law concerns.

## 8.5 Warranty, Manufacturer's Guarantee and Product Liability

### 8.5.1 Warranty

The buyer of a product enjoys extensive warranty rights under German legislation and may enforce such rights during a (in general) two years' limitation period commencing upon delivery. What is important to know is that the buyer is entitled to such rights only if the product was defective at the time of passing of risk from the seller to the buyer (which generally occurs upon delivery of the product to the buyer). Warranty rights may also be claimed if a product is not fit for purpose (either as contractually agreed, or its 'normal' purpose).

These statutory warranty rights include the right to request repair or replacement of defective goods. If such repair and replacement fails, the buyer has the right to rescind the contract and to claim reimbursement of the purchase price or to demand a reduction of the purchase price. The buyer may in addition also claim damages or reimbursement of its futile expenses.

Most of these warranty rights are obligatory in consumer contracts. In Business-to-Business contracts, the parties are free to determine the scope of the warranty provisions, provided that the respective clauses have been individually negotiated and agreed.

### 8.5.2 Manufacturer's Guarantee

A guarantee under German law is a contractual promise which grants rights in addition to – and not in lieu of – the buyer's statutory warranty rights (see Section 8.5.1). Unless otherwise agreed by the parties to a business-to-business contract, a manufacturer's guarantee cannot limit the statutory warranty rights of the buyer. Statutory warranty rights granted by German law can only be deviated from by way of individually negotiated clauses, not through

standard contracts (see Section 8.3). If a company provides its customers with a manufacturer's guarantee, such guarantee is not a substitute for applicable statutory warranty rights under German law and does not limit potential liability issues.

### 8.5.3 Product Liability

Both the manufacturer and its suppliers are liable under the German Product Liability Act as joint and several debtors. For the purposes of the Product Liability Act, any company that has been involved in the manufacturing process, labeled the products with its brand name and / or imported the products into the European Union / European Economic Area will be treated as a manufacturer. Furthermore, a distributor of the product can be deemed to be a manufacturer under certain circumstances if the (real) manufacturer or importer cannot be ascertained. Within the internal relationship between the manufacturer and the suppliers(s) of parts for the defective product, the party which has caused the damage will be liable. A limitation of liability in the relationship towards third parties is not possible. Liability under the Product Liability Act is irrespective of any fault or negligence (*verschuldensunabhängig*).

# Doing Business in Germany

# Typically German

*The gummy bear originated in Germany, where it is popular under the name **Gummibär** (gum or gummy bear) or in the endearing form **Gummibärchen** ([little] gum or gummy bear), gum arabic was the original base ingredient used to produce the gummy bears, hence the name gum or gummy. Hans Riegel, Sr., a confectioner from Bonn, started the Haribo company in 1920.*

\* Texts taken from publicly available sources (Internet etc.)



## 9 COMPETITION / ANTITRUST

The purpose of competition law is to ensure and protect effective competition as one of the fundamental principles of a functioning free market. Competition laws prohibit and sanction all agreements, practices and conduct which have a damaging effect on competition.

In the European Union (and thus also in Germany) another objective of competition law is to preserve a single European Union (EU) -wide common market which allows the free circulation of goods within the EU member states. In order to establish homogenous conditions for all companies, the Treaty on the Functioning of the European Union (“**TFEU**”) provides for a prohibition of cartels and other restrictive agreements as well as of conduct which abuses a dominant market position. The prohibition is applicable in all EU member states, thus also in Germany. In addition, concentrations between companies which exceed certain turnover thresholds in the EU are reviewed and examined under EU merger control rules. The European Commission in Brussels, Belgium, is the competition authority at EU level.

In addition to the TFEU in each EU Member State the respective national competition laws apply for conduct which just has a domestic effect. In Germany, the national competition law framework is provided by the German Act against Restraints of Competition (*Gesetz gegen Wettbewerbsbeschränkungen* – “**ARC**”) which contains regulations against restrictive agreements and abusive conduct as well as the German merger control rules. German competition law applies to all restraints of competition regardless of whether they are committed within or outside of Germany, as long as they have an effect on the German market. Compliance with German competition law is monitored and enforced by the Federal Cartel Office (*Bundeskartellamt*) and the regional competition authorities in each of the German Federal State (*Bundesländer*).

*Bi- or multilateral agreements between companies affecting trade between EU member states fall under both German and EU competition laws. In case of a conflict of laws, EU law prevails. With respect to unilateral conduct, German law is for certain areas stricter than EU law. In the area of merger control, depending on the turnover of the companies involved either EU or German law applies and thus a transaction is notifiable either with the European Commission or with the German Federal Cartel Office.*

## **9.1 Merger Control**

As part of their respective merger control regimes, both the European Commission and the Federal Cartel Office are responsible to examine concentrations between companies. Depending on the turnover of the parties concerned by the transaction, either the European Commission or the Federal Cartel Office has jurisdiction over the assessment of a transaction.

### **9.1.1 EU Merger Control Rules**

The key regulation in this context is the European Merger Regulation No. 139/2004. The European Commission must be notified of and must approve all transactions with a “community dimension” (as explained below). A concentration within the meaning of the European Merger Regulation occurs when two or more companies merge to form a new independent company, or when one or more companies acquire sole or joint control of another company through the acquisition of shares or assets. Control is acquired when one company is capable of exercising decisive influence over another company either through ownership or through the power to determine its strategic commercial behavior. The acquisition of a minority shareholding may, depending on the circumstances, also constitute a concentration within the meaning of the European Merger Regulation. Joint ventures can only be subject to EU merger control where they are intended to fully and independently operate in a market on a lasting basis and do not only perform selective functions for their parent companies.

## 9.1.2 Applicability of EU Merger Control Rules

The decision as to whether the European Commission needs to be notified of a transaction is based on the concerned companies' worldwide, EU wide and national turnover. The "community dimension" is met when in the last completed business year:

- the companies concerned had a combined aggregate worldwide turnover of more than EUR 5 billion; and
- the EU wide turnover of at least two of the companies concerned exceeded EUR 250 million;

or

- the companies concerned had a combined aggregate worldwide turnover exceeding EUR 2.5 billion; and
- the EU wide turnover of at least two of the companies concerned exceeded EUR 100 million; and
- in each of at least three EU member states, the combined aggregate turnover of the companies concerned exceeded EUR 100 million; and
- in each of these three EU member states, the turnover of at least two of the companies concerned exceeded EUR 25 million,

unless more than two-thirds of the aggregate EU wide turnover of each of the concerned companies is achieved within one and the same EU member state. For the purposes of the calculation of the threshold, the turnover has to include for the acquirer the turnover of the entire group and for the target only the turnover of the shares / assets to be acquired. The turnover has to be based on consolidated and audited figures of the last completed business year.

Where these thresholds are met, only the European Commission has jurisdiction over the intended transaction, and it will not be further reviewed under national merger control rules in the affected EU and European Economic Area member states. Where these thresholds are not met, merger filings at a national level may still be required.



*Where the intended merger does not meet the EU thresholds, but is capable of being reviewed under the national merger control laws of at least three EU member states, the companies concerned may request that the European Commission examines the concentration instead of the competent national authorities. If the respective EU member state does not object such referral, the transaction will be examined by the European Commission under the EU Merger Regulation.*

### 9.1.3 EU Notification and Review Procedure

The transaction must be notified and cleared prior to its implementation. Where the transaction involves an acquisition of control, the notification must be made by the purchaser. For a joint venture, all parties involved are obliged to make the notification. It is standard practice to establish contact with the European Commission prior to filing the notification. Notifying a transaction to the European Commission does not trigger a fee.

Where a concentration does not raise any competition concerns, the European Commission must take a decision within 25 working days of the notification having been filed (Phase I). This period can be extended to 35 working days when the parties propose to enter into commitments in order to remove the European Commission's preliminary concerns. Where the European Commission finds that the notified concentration raises serious doubts, it will carry out a full and in-depth investigation (Phase II) which can take up to another 90 working days before a final decision is reached. This time limit can be further increased to 105 working days where the parties propose to enter into commitments after the 55th working day of Phase II. Under specific circumstances, the review period can also be further extended.

*Transactions that must be notified to the European Commission must not be implemented prior to clearance being obtained. Upon request and only in exceptional cases, the European Commission may grant a derogation from the suspension obligation. If the parties fail to notify a concentration with a Community dimension, or if a transaction is implemented prior to clearance, the European Commission may impose fines of up to 10% of the parties' respective group turnover. Where incorrect, incomplete or misleading information is given, the European Commission may further impose fines of up to 1% of the aggregate group turnover.*

#### 9.1.4 Decision/Appeal under EU Merger Control Rules

The European Commission will either clear or prohibit the intended transaction. It can also clear the transaction subject to conditions or obligations (e.g. the order to divest a certain part of the business). Decisions of the European Commission can be appealed within two months to the European General Court.

#### 9.1.5 German Merger Control Rules

In Germany, merger control is governed by the German ARC. Sole responsibility for the examination of concentrations lies with the Federal Cartel Office.

#### 9.1.6 Applicability of German Merger Control Rules

German merger control rules apply where the transaction does not fall under the jurisdiction of the European Commission. In addition, German merger control law also requires the acquisition of minority shares to be notified, e.g. the acquisition of 25% of the capital or voting rights of a company, or even the acquisition of lower shareholdings if they result in a "competitively significant influence".

A concentration has to be notified when certain turnover thresholds are met, more specifically, when, in the last completed business year:

- a combined aggregate worldwide turnover of the companies concerned was more than EUR 500 million; and
- one of the companies concerned had a domestic turnover in Germany of more than EUR 25 million; and
- another company concerned had a domestic turnover in Germany of more than EUR 5 million.

Certain exceptions apply, e.g. if the seller is a *de-minimis* company with a worldwide turnover of less than EUR 10 million. .

### 9.1.7 German Notification and Review Procedure

One party to the concentration (in practice, usually the acquirer) must file a complete notification containing certain information on the transaction, the companies involved, and the markets possibly affected by the concentration, i.e. the parties' market shares on the relevant market. The Federal Cartel Office charges a fee for the review up to EUR 50,000 (in most cases between EUR 5,000 and EUR 15,000).

The review period for the Federal Cartel Office generally is one month from receipt of the complete notification (so-called Phase I review). Within Phase I, the Federal Cartel Office has the power to initiate an in-depth investigation (Phase II) if the transaction raises competition concerns, which can lead to a possible extension of the time period by another three months (which can under certain conditions be further extended). This review period can be further extended by one month where the parties propose to enter into commitments. If the Phase I or Phase II periods expire without any decision from the Federal Cartel Office, the transaction is deemed to be cleared.

*The parties must not complete or implement the transaction prior to the Federal Cartel Office's decision. The Federal Cartel Office may only grant derogation from this rule if the suspension would otherwise cause severe harm to the parties involved or to third parties.*

*In the event of a failure to file, or where a transaction is completed prior to clearance being obtained, the Federal Cartel Office can impose fines up to 10% of the concerned parties' aggregate turnover. Fines of up to EUR 100,000 may be imposed if the parties provide incorrect or incomplete information.*

### 9.1.8 Decision/Appeal/Violations under German Merger Control Rules

The Federal Cartel Office will either grant clearance or prohibit the intended transaction. It may further grant clearance subject to conditions or obligations (e.g. the order to divest a certain part of the business). The German ARC requires that, once clearance is obtained, the parties must also notify the Federal Cartel Office of the transaction being implemented. Decisions of the Federal Cartel Office can be appealed to the Court Of Appeals in Düsseldorf (*Oberlandesgericht Düsseldorf*) within one month from the decision.

## 9.2 Prohibition of Cartels and other Restrictive Agreements

Both, the TFEU and the German ARC prohibit any agreements between companies that restrict competition. In this area, German law is almost entirely harmonized with EU law. All agreements, arrangements and concerted practices between companies which have the object or effect of preventing or restricting competition are prohibited. Agreements may be formal or informal, written or oral; even implied understanding may constitute an arrangement, which is prohibited.

### 9.2.1 Horizontal Agreements

Horizontal agreements are agreements between companies that are actual or potential competitors in at least one of the markets affected by the agreement. Agreements restricting competition are, for example, co-operations between competitors which lead to the allocation of territories or customer groups, while excluding other competitors. Furthermore, all agreements between competitors

intended to fix or coordinate prices or other terms or conditions of sale are prohibited. Both price fixing and market sharing are fundamental anti-competitive acts and lead to severe penalties under German and EU competition law. In addition, any agreement with potentially competing bidders regarding the level or frequency of bids is prohibited; this is not only an infringement of competition law, but also a criminal offence in Germany, carrying the risk of fines or imprisonment of up to five years.

In general, the above rules may even apply to the mere exchange of information with competitors. The disclosure of competitively sensitive information to a competitor is prohibited, if it could appreciably affect competition. Even a one-time information exchange between competitors is deemed to violate competition rules. Companies should avoid communicating detailed and non-aggregated information regarding pricing, customers or future strategies to any actual or potential competitors.

There are horizontal co-operations between competitors, which are under certain conditions allowed under EU and German competition law, such as agreements concerning the joint purchase of products, the joint marketing, joint research and development, joint production / specialisation. In case the combined market share of the parties to the co-operation does not exceed a certain threshold and the co-operation does not contain any so called "hard-core" restriction such as price fixing or the allocation of customers and territories, it is likely that it would not be prohibited under the EU and German competition law rules. Furthermore, co-operations that are required if none of the companies would be able to independently carry out the planned project can give rise to efficiency gains and are therefore unlikely to be prohibited.

*Information exchange between competitors is also critical in the course of preparing M&A transactions. Until completion of the intended transaction, all parties involved must, at all times, remain competitors and act accordingly.*

## 9.2.2 Vertical Agreements

Vertical agreements are agreements between companies which are in a supplier/customer relationship, for example the seller of a product and its distributor.

For instance, it is prohibited to control or attempt to control (by way of threats or incentives) the price at which a buyer may resell a product. All parties must remain free to set their own pricing independently. Companies should always avoid any behavior that may give the impression of trying, whether directly or indirectly, to impose pricing conditions on their distributors. In addition, vertical agreements including exclusive supply or exclusive purchase obligations may be prohibited, depending on the market share of the parties concerned and on the duration of the contract. Furthermore, given that a free European common market is the background of EU competition law, all practices that aim directly or indirectly at restricting the free circulation of goods within the EU by restricting sales to only selected national markets are prohibited.

## 9.2.3 Exempted Agreements

Both EU and German competition law provide for certain exemptions from the prohibition of anti-competitive agreements. An otherwise anti-competitive agreement will be exempt from the general prohibition if it contributes to improving the production or distribution of goods or to the promotion of technical or economic progress, provided it allows consumers a fair share of the resulting benefit and it does not impose restrictions which are not indispensable to the attainment of these objectives and provided it does not afford the possibility of eliminating competition on respect of a substantial part of the products in question.

*More importantly, the EU law block exemption regulations provide that, on the basis of relatively clear-cut rules, certain groups of agreements are exempt from the prohibition. These regulations are also directly applicable under German competition law. Block exemption regulations exist, for example, in the fields of distribution, transfer of technology, the automotive sector, and research and development.*

### 9.3 Abuse of a Dominant Position

Where a company holds a dominant position and thus is not exposed to competitive pressure, its conduct is subject to more intense competition law scrutiny. The most relevant factor in determining whether such a dominant position exists is the market share of the company, as well as its ability to influence prices or the quality of goods on the market for a significant period of time. As a general rule, a company should at all times avoid making statements that suggest it considers itself dominant on any market.

*In the field of abuse of dominance, EU and German law differ. Inter alia, German law stipulates the (rebuttable) presumption that a company is dominant when it has at least a market share of 40%, whereas EU law does not stipulate a clear threshold, rather examines dominance and usually finds this to exist with a market share of 40-50%.*

The German ARC differentiates between two main forms of abusive conduct: on the one hand, it prohibits the abusive exploitation of a dominant position by one or several companies. On the other hand, it regulates the conduct of companies which do not hold a dominant position but which have a superior market power because other companies depend on them. Abusive conduct occurs, for example, where a dominant company denies its smaller competitors access to its networks or other facilities that are essential in order to operate in a competitive manner. In addition, the refusal to supply certain customers, or otherwise discriminate without objective justification, constitutes an abuse. This also applies when a dominant or a player with superior market power in a certain product market allows the purchase of its popular or indispensable product only if the customer agrees to buy certain additional products.

In this context, pricing strategies carry multiple risks in relation to infringement of competition law. Companies in dominant market positions are not permitted to grant certain kind of rebates or discounts in order to tie in customers (e.g. loyalty rebates). Companies with market power are not permitted to sell products below cost with the purpose of weakening other competitors' market positions or hindering potential competitors from entering the relevant market. Furthermore, it is prohibited to demand excessively high prices or to differentiate between customers through price or terms and conditions of sale.

## 9.4 Self-assessment

In areas other than merger control, the European Union and German competition law regimes do not provide for a notification system. As a rule, the authorities will not review agreements or unilateral conduct, and give their green light. That requires that companies must themselves examine whether their activities comply with competition rules and whether an agreement or co-operation they have entered into might be prohibited, or may qualify for an exemption. Both the European Commission and the Federal Cartel Office have issued guidelines and information in relation to possible exemptions such as the *De Minimis* Notice, which highlights the approach taken by the European Commission in relation to conduct that will probably not affect competition in any appreciable way.

## 9.5 Authorities' Powers

Both the European Commission and the Federal Cartel Office have investigative powers that resemble the powers of other enforcement agencies. Competition authorities are entitled to raid a company's premises, to interrogate witnesses and collect books and electronic data. Opposition to an investigation is likely to result in significant fines. The competition authorities can require the companies concerned to terminate all agreements, decisions and concerted practices which constitute an infringement of a provision of the German ARC or the TFEU. In addition, they are entitled to take and impose all measures which are necessary to bring the infringement to an end. Competition authorities are further empowered to impose fines on the companies involved with the infringement. In particular, hardcore cartels which cause significant distortions of competition, such as price fixing agreements, may be sanctioned with severe fines of sometimes hundreds of millions of Euros. Fines can theoretically amount to up to 10% of the total worldwide group turnover of the infringing companies. Under German law, even responsible individuals (e.g. the CEOs/managers of a company) could also be imposed with a fine of up to EUR 1 million.

### 9.5.1 Appeal

Decisions of the European Commission can be appealed to the European General Court in Luxembourg. Appeals against the decision of the European General Court can be filed with the European Court of Justice in Luxembourg.



Decisions of the Federal Cartel Office can be appealed to the Court of Appeals (*Oberlandesgericht*) in Düsseldorf. Appeals against the decisions of the Court of Appeals in Düsseldorf can, under certain circumstances, be filed with the Federal Court of Justice (*Bundesgerichtshof*) in Karlsruhe.

### 9.5.2 Leniency

Both the European Commission and the Federal Cartel Office can grant immunity or a reduction in fines to companies which actively help in uncovering a cartel in which they participated.

*Full immunity will only be granted if the company is the first of the participants to contact the competition authorities before these have gathered sufficient evidence on their own and if the company did not force other companies to participate in the cartel. If a company discovers that it was involved in an illegal cartel, time is of essence.*

Where companies do not qualify for immunity the fine may still be reduced if the company fully cooperates and provides evidence or significantly valuable information. Both the European Commission and the Federal Cartel Office provide special fax and telephone numbers under which an application for leniency can be made.

# Doing Business in Germany

# Typically German



**Lederhosen** (German for leather breeches; singular: Lederhose) are breeches made of leather; they may be either short or knee-length. There is a widespread misconception that Lederhosen are a traditional national costume (Tracht) in German-speaking countries. Today, Lederhosen are mainly worn to the Oktoberfest and other traditional Bavarian fairs.\*

\* Texts taken from publicly available sources (Internet etc.)

## 10 CUSTOMS & DUTIES

### 10.1 Introduction

The German customs system is mainly governed by European Community regulations. In light of the customs union, the key objective of the customs regulations is to provide a legal framework which is applicable in all European Union member states for goods entering the European Union. The exchange of services or capital does not fall within the ambit of customs legislation. This is the main difference from the VAT regime, which also taxes the exchange of services.

As a general rule, the person who will be responsible for compliance with the customs obligations for goods entering the European Union must be agreed upon between the supplying party and the purchasing party prior to the import of goods. In practice, contract parties often agree on INCOTERMS to determine their contractual responsibilities in this respect. Either the selling or the purchasing party may also elect to appoint a representative to assume the customs obligations.

The person making the customs declaration for the importation of the goods has to be established in or reside in the European Union. Any person established / resident outside of the European Union that wishes to assume customs responsibilities and act and be recorded as the importer has to appoint a representative who is established / resident in the European Union. Such person then acts in its own name, but for the account of the non-European Union person ("indirect representation").

*Indirect representation enables a non-European Union person to import goods into the European Union with full assumption of the customs obligations.*

## 10.2 Clearance for Free Circulation

If goods are imported into the European Union ultimately to enter into the economic cycle, they have to be cleared for free circulation. The purpose of clearance for free circulation is to fulfill all import formalities so that the goods can be sold in the European Union in the same way as any goods produced in the European Union. The customs debt on importation is incurred through the release for free circulation of goods which are liable to import duties.

Any customs debt incurred is based on the Community Customs Tariff. If the Community Customs Tariff provides for a duty exemption (e.g. for the majority of IT-related goods such as personal computers), the goods may enter the European Union without any customs duties having to be paid.

The second element which influences the amount of customs duty is the customs value of the imported goods.

### 10.2.1 Community Customs Tariff

Any merchandise imported into the European Union has to be classified under the Community Customs Tariff. The tariff classification is necessary to determine the applicable rate of duty.

*Even if goods are imported under a duty exemption, tariff classification is still required in order to determine potential import licenses, to establish whether import restrictions are applicable or to determine the code to be declared for statistical purposes.*

The Community Customs Tariff Nomenclature is a systematic classification of goods that is organized in a hierarchical structure, starting with large groups, which are further broken down into several stages and given a code (e.g. "20: Preparations of Vegetables, Food, Nuts or other Parts of Plants", "2009: Fruit Juices and Vegetable Juices", "2009 50: Tomato Juice", "2009 50 90: Tomato Juice not containing added sugar").

## 10.2.2 Customs Value

To the extent that the Customs Tariff provides for duties to be paid on imported goods, the applicable rate is a percentage of the value of the product (*ad valorem duties*).

The primary method of customs valuation is to establish the "transaction value", which is the purchase price the importer actually has to pay to its supplier. In principle, the customs value is to cover all costs arising up to the EU-border (CIF value). If the purchase price does not cover all such costs, the Customs Code then sets out items which are to be added to the purchase price. The main items are:

- Commission and brokerage fees (except buying commissions);
- Assists, i.e. goods and services supplied directly or indirectly by the buyer free of charge or at a reduced cost for use in the production and sale of the imported goods (e.g. tools, molds, engineering);
- Royalties and license fees related to the goods being imported, that the buyer must pay as a condition of the sale of the goods; and
- Transportation and insurance costs associated with the transporting of the imported goods to the place of introduction into the European Union.

The Customs Code also allows for a deduction of certain items from the purchase price if they are shown separately on the invoice. The main deductions are:

- Transportation costs after the place of introduction into the European Union;
- Charges for interest under a financing arrangement;
- Charges for the right to reproduce imported goods in the Community;
- Buying commissions (i.e. fees paid by an importer to its agent for the service of representing it in the purchase of the goods being imported); and
- Import duties and other charges payable in the Community.

If the transaction value method cannot be applied (e.g. due to lack of a sale and purchase agreement), the Customs Code sets out alternative valuation methods which are:

- The transaction value of identical goods;
- The transaction value of similar goods;
- The value based on the unit price at which the imported, identical or similar goods are sold within the European Union (deductive valuation method);
- The sum of costs of material in fabrication, including an amount for profit and general expenses and the costs for transportation and insurance (computed valuation method).

### 10.3 Special Procedures

Special customs procedures can be used to avoid payment of customs duties at the time of importation. The most relevant are:

- Customs warehousing, where the sale on the European market is envisaged at a later stage or where the goods are going to be re-exported into a non-European Union country after storage;
- Inward processing, where the goods are intended to be re-exported to a non-European Union country after processing;
- Temporary importation, where the goods are to be used in the European Union on a temporary basis and subsequently re-exported to a non-European Union country (e.g. display of samples in trade fairs).

# Doing Business in Germany



# Typically German

*The **Volkswagen Type 1**, widely known as the Volkswagen Beetle, is a car produced by the German car manufacturer Volkswagen AG (VW) from 1938 until 2003. With over 21 million manufactured in an air-cooled, rear-engined, rear-wheel drive configuration, the Beetle is the longest-running and most-manufactured automobile of a single design platform anywhere in the world.\**

\* Texts taken from publicly available sources (Internet etc.)



## 11 EXPORT CONTROLS

The general approach taken by German policy is that exports should be encouraged rather than impaired. However, Germany has established a comprehensive system of export controls.

The main rules regarding export controls are laid down in the European Dual Use Regulation (Regulation 428 / 2009), the Act on Foreign Trade (*Außenwirtschaftsgesetz*) and the Statute on Foreign Trade (*Außenwirtschaftsverordnung*). German export control administration is divided between the Federal Office for Economics and Export Control (*Bundesamt für Wirtschaft und Ausfuhrkontrolle*) and the customs administration.

While the Federal Office for Economics and Export Control is responsible for deciding whether a certain export requires a license and, if so, whether a license will be granted, it does not exercise any policing powers. Instead, the customs administration monitors and supervises whether companies comply with export control regulations.

*There are two types of exports, both of which are subject to German export control regulations: tangible exports, i.e. where items physically depart from Germany, and intangible exports, i.e. the transmission of software or technology using telecommunications services.*

### 11.1 Export of Military Items

The export of military items to any country requires an export license. The designation of items as military depends on their technical features and on whether they have been designed or modified for military use. Items are not classified as military items merely because they are sold to a military customer, such as the police or armed forces. Items sold to a civil customer are deemed to be military items, if they conform to the specifications of the military list as set forth by the German Government as part of the Statute on Foreign Trade.

## 11.2 Export of Dual-Use Items

The export of dual use items to non-EU countries also requires an export license. Whether items are subject to export controls as dual use items must be determined in accordance with the European Dual Use List which is part of the European Dual Use Regulation, and German law which provides for a few additional categories of dual use items. When determining whether particular items conform to one of the categories of controlled items, a careful analysis of the technical features of the item is required.

In addition, export licenses may also be required for exports of unlisted items, if one of the following applies:

- The exporter knows or has been informed by the Federal Office for Economics and Export Control that the items to be exported are intended to be used in connection with weapons of mass destruction or missiles capable of delivering weapons of mass destruction;
- The export is destined for a country against which an arms embargo is in place, and the exporter knows or has been informed by the Federal Office for Economics and Export Control that the items to be exported are intended for a military end-use; or
- The export is destined for a country which the German government considers to be a thriving market for nuclear weapons or where the German government believes there is a special risk for proliferation of nuclear weapons and the exporter knows or has been informed by the Federal Office for Economics and Export Control that the items to be exported are intended for use in or in connection with a nuclear plant or installation (including nuclear power plants).

### 11.3 Technical Assistance

Under certain conditions, providing "technical assistance" also requires a formal export license. Technical assistance, i.e. any technical support or technical service, can take the form of instruction, training, transfer of practical knowledge or abilities or consultation, including assistance by telephone or electronic media or the provision of technology (e.g. documents or files) to non-German nationals.

Providing technical assistance requires an export license if:

- The company providing the support knows or has been informed by the Federal Office for Economics and Export Control that the support will be used in connection with weapons of mass destruction or with missiles capable of delivering weapons of mass destruction and the support is provided to a non-German national who is not resident in Australia, Canada, Japan, New Zealand, Norway, Switzerland or the USA or the support is provided outside the European Union; or
- The company providing the support knows or has been informed by the Federal Office for Economics and Export Control that the support is related to a military end-use and the support is provided in a country under an arms embargo or to persons resident in these; or
- The company providing the support knows or has been informed by the Federal Office for Economics and Export Control that the support is related to a nuclear plant or installation in a country which the German government considers to be a thriving market for nuclear weapons or where the German government believes there is a special risk for proliferation of nuclear weapons.

### 11.4 Embargos and Sanctions

The European Union has adopted a number of embargos and sanctions against countries considered to be aggressors or to be engaged in massive violations of human rights. For a number of years, the European Union has been following a "Smart Sanctions" approach, targeting individual persons, corporations, or

single industries within the embargoed country. In addition, the European Union has adopted financial sanctions against a number of individuals, corporations and groups, so-called Designated Parties. Financial sanctions have been adopted in anti-terrorism sanctions, but also in connection with embargoes adopted against specific countries.

Germany has implemented the embargoes and sanctions adopted by the European Union. While it has marginally broadened the scope of some embargoes, Germany has not adopted embargoes of its own. Current information on embargoes and sanctions implemented by Germany may be retrieved from the website of the Federal Office for Economics and Export Controls ([www.ausfuhrkontrolle.info](http://www.ausfuhrkontrolle.info)).

*As the European Union considers the effect of certain US legislation implementing embargoes against Cuba and Iran to be extraterritorial, it has adopted a set of sanctions to block such US legislation. For a European company, these so-called US Blocking Sanctions make it illegal to comply with certain US laws.*

## **11.5 Early-warning Lists**

Germany has not adopted its own lists of Designated Parties. The German authorities, however, have compiled early-warning lists. These lists include persons and entities which Germany suspects to be involved in the proliferation of nuclear weapons or in international terrorism. If an export is destined to a person or an entity included in an early-warning list, customs will hold the shipment and will not process the export until an export license has been provided.

*The early-warning lists are not in the public domain. Information as to whether a particular entity is listed may be requested from the Federal Office for Economics and Export Control or the local Chamber of Industry and Commerce.*

## 11.6 Export Licenses

There are two types of export license available in Germany: Individual Licenses and General Licenses.

Individual Licenses can be granted as a single license (*Einzelgenehmigung*) covering one export to one particular consignee, or as a maximum value license (*Höchstbetragsgenehmigung*) covering several shipments of items to one particular consignee up to the total value set out in the license. A maximum value license can, for example, cover the expected annual turnover with a single consignee. Exporters who have been granted a high number of export licenses within a short timeframe can obtain a collective license (*Sammelgenehmigung*), which covers the shipment of a range of items to several consignees.

In order to facilitate export licensing procedures, the European Union and the German Federal Office for Economics and Export Control have issued several General Export Licenses. For exports which are within the scope of these General Licenses, no application is required. Instead, only certain basic formalities need to be complied with. General Export Licenses are of immense practical relevance, as they allow immediate exports of otherwise restricted items, and provide for planning reliability. General Licenses can be used for exports of those items to those countries listed in the relevant license. General Licenses have been issued for both military and dual use items. Of most practical value are the following General Licenses:

- Union General Export Authorization No.1 (UGEA001): UGEA001 applies to exports destined for Australia, Canada, Japan, Liechtenstein, New Zealand, Norway, Switzerland and the USA. UGEA001 covers most dual-use items included in the European Dual-Use List.
- German General License 16 (GA-16): GA-16 applies to exports of telecommunications items. GA-16 also covers the export of most basic cryptography items to most countries in the world.
- German General License 12 (GA-12): GA-12 covers shipments of controlled items whose value does not exceed EUR 5,000 to most countries in the world.



# Doing Business in Germany



# Typically German

**Schloss Neuschwanstein** (Neuschwanstein Castle) is a 19th-century Gothic Revival palace on a rugged hill above the village of Hohenschwangau near Füssen in southwest Bavaria, Germany. Neuschwanstein was commissioned by King Ludwig II of Bavaria as a retreat and as a homage to Richard Wagner. Neuschwanstein has prominently appeared in several movies and was the inspiration for Disneyland's Sleeping Beauty Castle and later, similar structures. Today, Neuschwanstein is one of the most popular palaces and castles in Europe. Every year around 1.4 million people visit Neuschwanstein.

\* Texts taken from publicly available sources (Internet etc.)



## 12 INTELLECTUAL PROPERTY

Technical inventions, works of art, and famous trademarks would not be possible without the creative performance of the people behind those achievements. Intellectual property and copyright protection are vital measures to safeguard such achievements. During the course of globalization, the economic importance of intellectual property has increased significantly, in line with the technological progress made in all industries and together with the growing demand for consumer goods.

Nowadays, the value of a company and its capacity to survive in an internationally competitive market is, to a high degree, defined by its innovations. Research and development involves considerable investment, and the valuable outcomes of the research and development process deserve the protection afforded by the German legal system's comprehensive IP laws. The main areas of protection are patents, utility models, trademarks, design and copyrights.

### 12.1 Patents and Utility Models

#### 12.1.1 Patents

Patents are registered rights for technical inventions, granting to the holder of the patent the exclusive right to use the relevant invention as determined by the terms of their patent. Utility models are similar registered rights for technical inventions of a lesser importance.

All relevant areas of patent law are governed by federal statutes, in particular the German Patent Act. In addition, provisions governing patents are found in a number of regulations passed under European patent laws, as well as international treaties, such as the Patent Cooperation Treaty.

*To qualify for a patent, a technical invention has to meet three conditions: (i) novelty, (ii) inventive step, and (iii) it has to be capable of industrial application.*

### 12.1.2 Obtaining Patent Protection

Up to now, a European patent with unitary effect which would be valid in all member states of the European Union does not exist. However, the implementation of such unitary patent is imminent. Until then, patent protection for an invention can be obtained by filing a national application with the German Patent and Trademark Office. Protection can also be achieved by filing a European application with the European Patent Office designating Germany, or by filing an application under the Patent Cooperation Treaty. However, no matter which approach is taken, it will always be a national German patent that will be granted.

### 12.1.3 Key Features

The maximum term of patent protection is 20 years. Germany has adopted the inventor-principle instead of the "first-to-file" principle, i.e. the right to a patent belongs to the inventor or his legal successor, not to the party who first files the patent application. Patentable subject matters do not include discoveries, scientific theories, business models, and aesthetic creations.

### 12.1.4 The German Patent Court System

The German court system differentiates between nullity of a patent and infringement of a patent. Matters of validity of a patent are dealt with by the German Patent and Trademark Office and the Federal Patent Court (*Bundespatentgericht*), whereas infringement proceedings are held before one of the 12 district courts with chambers specialized in patent cases. The specialized German patent infringement courts are highly regarded for their significant experience and expertise, which is why they are very popular for infringement proceedings throughout Europe.

*In general, the patentee or owner of a utility model is entitled to sue the infringer for (i) injunctive relief, (ii) damages and (iii) disclosure of the scope of an infringing use.*

### 12.1.5 Patent Enforcement

Regarding monetary compensation, German patent law offers three methods of calculating damages: the patentee may file for (i) his lost profits, (ii) license analogy (reasonable royalties) or (iii) the profit generated by the infringer with the infringing products. Unlike US laws, German patent law does not provide for punitive damages.

### 12.1.6 Utility Models

Protection can also be sought for particular utility models (*Gebrauchsmuster*). The requirements to obtain protection for a utility model are broadly similar to those for patent protection, with only slight differences regarding the aspects of novelty and inventiveness. Contrary to patents, the German Utility Model Act does not provide for protection of a manufacturing or processing method. Utility models are only examined for formal requirements on application. Unlike patents, the German Patent and Trade Office does not examine the aspects of novelty, inventive step or industrial applicability when applying for utility model protection. As a result, utility models can be obtained more quickly and more cost efficiently than patents.

## 12.2 Employee Inventions

Technical inventions generated by an employee as a result of the employee's task or activity in the company or based on experience the employee gained while being employed with the company are subject to the German Act on Employee Inventions. This Act explicitly sets forth that the right in the respective inventions is automatically transferred to the employer unless the employer expressly waives this right within four months from the receipt of the employee's report of the invention. The employee may claim reasonable remuneration from the employer as soon as the employer acquires the rights in the respective invention.

*Employers should carefully evaluate inventions reported by their employees and immediately object to the acquisition of inventions which appear to be useless. Otherwise, they might face remuneration claims for inventions which are economically unviable.*

### 12.3 Trademarks

Trademarks serve to distinguish goods or services from one enterprise from goods and services of others and, thus, serve as an indication of origin. Pursuant to the German Trademark Act, an exclusive right can be acquired for trademarks, business designations and designations of geographic origin.

*In principle, any sign which is capable of distinguishing the goods or services of different companies, is capable of being protected as a trademark. The protection may include e.g. personal names, designs, letters, numerals, two and three dimensional shapes of goods or their packaging and sounds.*

In Germany, protection for a registered trademark can be obtained by filing an application for a German trademark with the German Patent and Trademark Office, by filing an application for a Community Trademark with the Office for Harmonization in the Internal Market, or by filing an application for international registration with the World Intellectual Property Organization based on a basic national application or registration. The major requirements for trademark registration to register are that the trademark applied for must be capable of being represented graphically and with respect to the claimed goods and services is neither devoid of distinctive character. If the application meets the requirements, the trademark will be recorded in the register and the registration will be published.

*The protection period of a registered German trademark begins with the date of filing of the application, expires after 10 years and can be renewed for further 10-year periods.*

Upon registration, proprietors of earlier filed or registered trademarks have the opportunity to file an opposition against the registration within a period of three months starting from publication of the trademark application. A opposition can primarily be based on the grounds that the trademarks at issue are identical or similar and cover identical or similar goods or services. Furthermore, the opposition can be based on the argument that the earlier trademark possesses a particular reputation in Germany. Regardless of any opposition, a registered trademark can be cancelled upon request, if it has not been put to genuine use within a continuous period of five years after the date of registration.

Apart from registration, trademark protection may accrue under the German Trademark Act through use of the sign in the course of business if the sign has acquired a secondary meaning as a trademark, or by notoriety. Trademarks established by registration, by use, or by notoriety may be assigned, licensed or utilized as debt security.

*The proprietor has a claim against any infringer for injunctive relief and claims for disclosure as well as a claim for damage, if the infringement was undertaken intentionally or negligently.*

## 12.4 Design Protection

A design right protects the aesthetic aspects of industrial products, such as color and shape. These may include, inter alia, ornaments, textiles, devices, motor vehicles, labels, brochures, and other essentials creating an aesthetic difference between products in competition.

National applications for a registered design are to be filed with the German Patent and Trademark Office. The application for a registered design have to include pictures or drawings reproducing the design. Usually, the registration and publication of a design can be expected within three to five months after filing. The term of protection is five years, but the term may be extended four times to a maximum total of 25 years. Applicants not having a place of business or branch within the European Union will have to be represented by an attorney or patent agent admitted in Germany.

A Community Design protects a design in the entire European Union for up to 25 years within the territory of the European Union. This registered Community Design can either be filed with the Office for Harmonization in the Internal Market directly, or with the German Patent and Trademark Office, which will forward the application to OHIM.

*Both the national German Design as well as the Community Design grant the owner the exclusive right to use the design and to exclude others from using it.*

In addition to a registered Community Design, the European Union system also includes an unregistered Community Design Right. The unregistered Community Design provides protection for three years from the day the design is made available for the first time to the public within the EU. This design right is granted by law without formalities and free of charge.

## 12.5 Copyright

Copyright protection in Germany accrues from the creation of the work and does not depend on registration or official grant. To be protected as a copyright, the protected work must exhibit a minimal amount of creativity. In a recent decision, the German Federal Court of Justice held that works of applied art do no longer require a special level of originality. Thus, works of applied art will now often not only be protectable as designs but also enjoy copyright protection. It has to be noted that a copyright only protects the concrete expression of an idea rather than the idea itself.

The subject of a copyright may be a work of literature, science or art, in particular, linguistic works, works of music, dance, works of fine art, photos, film, presentations of a scientific or technical nature and also computer programs.

The copyright owner has the exclusive right of commercial exploitation of his work. The exploitation rights, including the right to reproduce, distribute, exhibit and make the work available to the public, may be assigned on an exclusive or a non-exclusive basis. The copyright as such may, however, not be transferred under German law in view of the personal rights remaining with the author.

For the purpose of protecting the public interest, the exclusive right of commercial exploitation is limited in some respects (e.g. for private copies or for use in education and science). In order to compensate the author for such limitations of his copyright, the law provides for copyright levies which are generally claimed and enforced by collecting societies.

*Copyright protection expires 70 years after the author's death and in case of several joint authors 70 years after the death of the last surviving author. Anonymous and pseudonymous works are protected for 70 years after publication.*

The German Copyright Act provides for cease and desist claims and, where there is intent or negligence, for damages and criminal law sanctions. In addition to certain information rights, the copyright owner may require destruction or surrender of all unlawfully produced copies and of devices used for the unlawful products.

## **12.6 Unfair Competition**

Unfair competition encompasses the concepts of passing-off, impeding free competition, violation of statutory and contractual obligations, slander, libel, and deceptive advertising, as well as other deceptive acts or practices such as exploiting the naive or inexperienced.

Consumers and competitors alike are protected against unfair competition practices by the German Unfair Competition Act. The German Unfair Competition Act prohibits business practices which prejudice the interests of competitors, consumers and others in the market.

In particular, the German Unfair Competition Act prohibits: putting pressure on consumers to influence their decisions; exploiting the inexperience of children and teenagers; exploiting another's reputation; concealing terms and conditions of discounts and games when advertising these; slavishly imitating products not protected by IP rights; non-transparent and deceptive advertising; misleading advertisement with false prior prices; and cold calling by phone, fax or email. Generally, comparative advertising is not considered unfair if similar goods /



services for the same purposes are compared and a number of other requirements are met.

The standard limitation period for claims under the Unfair Competition Act is six months. The period commences when the circumstances giving rise to the claim arise, the claimant is aware of these circumstances, and the claimant knows the identity of the other party.

The Unfair Competition Act provides for cease and desist claims and – where there is intent or negligence – damages may be sought. . In addition, criminal liability can arise from the breach of certain provisions, e.g. the disclosure or unauthorized use of company secrets.

*Only competitors and competition associations (Vereinigung zum Schutz des Wettbewerbs), not consumers, can enforce rights under the German Unfair Competition Act.*

## 12.7 Customs Seizure

Germany has an elaborate and efficient framework for the protection of IP rights, which includes a procedure whereby one can apply for counterfeit goods and non-European Economic Area parallel imports to be seized by German Customs. In recent years, German Customs has proven to be highly efficient in combating IP infringements. Filing an application with the *Zentralstelle Gewerblicher Rechtsschutz* – the competent administrative body – is therefore recommended both for its effectiveness and for efficiency.

Upon filing a customs application, border and customs offices in Germany may stop or seize suspected goods during the customs clearance process. A customs application may be filed by the holder of the IP right, a licensee or a representative under power of attorney. An application can be filed in relation to trademarks, copyrights, designs, patents, utility models and other IP related rights.

The major benefits of implementing such custom seizure programs are:

- Both counterfeit goods and non-European Economic Area parallel imports may be seized and destroyed by German Customs;
- Infringing goods may be blocked on a European Union-wide basis;
- All expenses incurred are to be borne by the infringer so, given that both the German and the European applications are exempt from statutory fees, the seizure procedure is nearly cost-neutral;
- German Customs often act proactively and detain suspected goods even without a proper application having been filed by the owner of the IP rights;
- As regards criminal liability, a parallel application for public prosecution can be filed, and the brand owner can benefit from the findings of the public prosecutor's investigation; and
- German Customs and the *Zentralstelle Gewerblicher Rechtsschutz* offer a helpful resource centre for individuals seeking to familiarize themselves with German cross-border enforcement of IP rights.

## 12.8 Enforcement

The German legal system is relatively right-owner friendly and provides efficient remedies when it comes to the protection and enforcement of IP rights.

Under the relevant German IP laws, the infringed party is entitled to injunctive relief and damage claims against the infringer and, in part, to claims for destruction of infringing products and to information on the scope of the infringement as well as the commercial origin of the infringing products. The infringed party may in particular request the disclosure of relevant information such as sales figures and profits in order to calculate its damages. Some German courts have been generous with regard to damage claims and have, in some cases, ordered the infringer to surrender all profits generated from the infringing action.

Preliminary injunction proceedings are a very effective and fast way to protect IP rights against actual or threatened infringements. Preliminary injunction proceedings are usually conducted *ex parte*, and a decision can be expected within a period of one to four days. Preliminary injunction proceedings are only admissible if the matter is urgent. A matter will usually no longer be deemed to be urgent if more than around four to six weeks have passed since the infringed party gained knowledge of the infringement.

*In most cases, it is advisable to send a warning letter to the infringer before applying for a preliminary injunction.*

Under German law, the infringed party has a claim against the infringer for the reimbursement of legal costs to the amount of statutory fees. Depending on the value of the case, such a claim for costs can cover a significant part of the legal fees for the warning letter as well as of the legal costs of the preliminary injunction and main proceedings.

## 12.9 Technology Transfer

Technology transfer means the process of sharing and exploiting patented and unpatented technical information and material by licensing, transfer and / or joint research and development activities.

### 12.9.1 Licensing vs. Transfer

Under German law, there are no specific requirements for the transfer of know-how and patents, except for the so-called principle of certainty (*Bestimmtheitsgrundsatz*) which demands that the assets to be transferred are clearly identified. The parties to a license agreement are generally free to determine the subject matter and scope of the license. However, they have to comply with antitrust laws and, to the extent the license agreement contains standard terms and conditions, with the German Law on Standard Terms and Conditions.

## 12.9.2 Compliance with Antitrust Laws

Any license agreement must be compliant with European antitrust legislation. As a general rule, agreements which restrict competition are prohibited and the relevant provisions are likely to be void. In addition, the relevant cartel authorities may impose administrative fines of up to 10% of annual sales on the infringing party. Fines imposed have increased significantly over the last years.

The European Commission has also issued a regulation which provides for a "Technology Transfer Block Exemption". Together with the guidelines of the European Commission, the Technology Transfer Block Exemption provides some guidance on the drafting of license agreements permitting the production of contract products.

## 12.9.3 Insolvency Law

German insolvency law stipulates that reciprocal agreements, including license agreements which are not yet fully performed by both sides at the time the insolvency proceedings formally commence, are subject to an option of the insolvency receiver to either perform or terminate the agreement. As a result, in insolvency cases a licensee always runs the risk of losing the license and not being adequately compensated for this loss.

## 12.9.4 Research and Development Contracts

Unlike general licensing agreements, in R&D collaborations, new intellectual property is evolving and as a result, the question of ownership for such newly developed patents or know-how has to be taken into account.

Generally, there are three kinds of collaboration in the field of R&D:

- Co-operations (*Kooperation*);
- R&D services (*Forschungsauftrag*); and
- Contract works (*Werkauftrag*).

In all cases, ownership of newly developed intellectual property as well as licenses to pre-existing intellectual property need to be contractually determined.

# Doing Business in Germany

# Typically German



**Oktoberfest** is a festival held each year in the Bavarian capital Munich, Germany, running from late September to the first weekend of October. It is one of the most famous events in Germany and the world's largest fair, with more than 5 million people attending every year. The Oktoberfest is an important part of Bavarian culture. Other cities across the world also hold Oktoberfest celebrations, modeled upon the Munich event.\*

\* Texts taken from publicly available sources (Internet etc.)

## 13 DATA PROTECTION

In Germany, the general provisions on data protection are set forth in the Federal Data Protection Act (*Bundesdatenschutzgesetz*), which implements the European Directive 95 / 46 / EC on the protection of individuals with regard to the processing of personal data and on the free movement of such data.

In addition, industry sector specific data protection rules apply such as the Telecommunications Act (*Telekommunikationsgesetz*) for telecommunication services or the Telemedia Act (*Telemediengesetz*) for the telemedia services industry sector.

The Federal Data Protection Act applies if the party responsible for collecting, processing or using personal data either on its own behalf or on behalf of others (the "data controller") (i) is established in Germany and collects, processes and / or uses personal data in Germany; or (ii) is established in the territory of another member state of the European Union or of the European Economic Area, and collects, processes and / or uses personal data in Germany in the context of the activities of an establishment in Germany; or (iii) is established outside the European Union / European Economic Area, but uses equipment located within Germany to collect, process and / or use personal data.

### 13.1 Main Principles of the Federal Data Protection Act

The Federal Data Protection Act ensures the protection of the personal data of individuals (i.e. natural persons) and imposes strict requirements for the lawful collection, processing and / or use of such data. Personal data is defined as any information relating to personal or material circumstances of an identified or identifiable individual (the "data subject").

Collection, processing and use of personal data is governed by the principles of data avoidance and data economy. The personal data must be adequate, relevant and not excessive in relation to the purposes for which it is collected, processed or used. Furthermore, personal data must be accurate, kept up to date and must, in general, be collected directly from the data subject. As the data collection, processing and use must be transparent, the data subject must



be provided with the information necessary to ensure fair processing, such as the identity of the data controller, the type of data concerned, the categories of recipients and the purposes of the collection, processing and / or use. The data controller must take all reasonable technical and organizational measures necessary to ensure the security and confidentiality of the personal data. If personal data is inaccurate or illegally processed the data subject is entitled to have his / her personal data rectified, deleted, or blocked, or he / she can object to the processing.

### **13.2 Legal Requirements for Processing Personal Data**

The Federal Data Protection Act prohibits any collection, processing, and / or use of personal data unless such activities are expressly permitted or prescribed by a legal provision or if the data subject has validly given his / her consent.

The Federal Data Protection Act itself contains a number of specific requirements for legitimizing collection, processing and / or use of personal data. According to the most relevant provisions, the processing of personal data is justified if (i) the processing is necessary to create, perform or terminate a legal obligation or quasi-legal obligation with the data subject; or (ii) such processing is necessary to safeguard the justified interests of the data controller and there is no reason to assume that the data subject has an overriding legitimate interest in his / her data being excluded from the processing or use.

The processing of sensitive personal data (information on a person's racial or ethnic origin, political opinions, religious or philosophical beliefs, trade union membership, health or sexual life) is prohibited unless certain conditions are met, e.g. the data subject has validly given his / her consent or the processing is necessary to protect the vital interests of the data subject.

*Although usually it is not mandatory to obtain the consent of the data subject, it is often safer to obtain consent to justify the collection, processing and / or use of personal data. Consent, however, must be given voluntarily and, as a general rule, in writing, on the basis of information given about how the data will be used.*

Infringing the provisions of the Federal Data Protection Act will not only lead to adverse publicity: the infringing data controller may also face cease and desist claims, court actions for compensation or - in extraordinary circumstances - criminal liability. Furthermore, administrative fines of up to EUR 300,000 (arguably for each case) could be levied against the data controller.

### **13.3 International Transfer of Personal Data**

Transfers of personal data from Germany to other European Union / European Economic Area countries are generally permitted without a need for further approval, provided such transfers would be legal within Germany. Transfers of personal data from Germany to countries specifically approved by the European Commission as having an adequate level of data protection are also generally permitted (subject to the fulfillment of certain pre-conditions), provided that the transfers would be legal within Germany. These currently include Andorra, Argentina, Canada, Faeroe Islands, Guernsey, Isle of Man, the State of Israel, Jersey, New Zealand, Switzerland and the Eastern Republic of Uruguay. The same applies for the US, provided that the recipient adheres to the Safe Harbor Principles.

Transfers to the US (except as indicated above) or any other countries outside the European Union / European Economic Area that do not provide an adequate level of data protection are only permitted if the data exporter ensures an adequate level of data protection at the data importer, and only on the basis that the transfer would be legal within Germany. An adequate level of data protection at the data importer may, for example, be ensured if the data importer and exporter have validly entered into an agreement based on unmodified versions of the relevant European Commission Model Clauses. In such cases, the respective transfer is not subject to approval by the supervisory authority.

Transfers of personal data to countries outside the European Union / European Economic Area may also be permitted without additional measures being taken if, for instance, the data subject has consented to the transfer or the transfer is necessary for the performance of a contract between the data subject and the data controller.

### 13.4 Employee Data Protection

In Germany, the collection, processing and / or use of employees' personal data is restricted and, in particular, subject to co-determination rights.

*Employers are entitled to collect, process and / or use personal data if permitted by statute. The general approach of German data protection is that an employee cannot voluntarily consent due to the subordinate nature of his / her relationship with the employer.*

Technical developments which have taken place in recent years raise further privacy and data protection concerns. Companies are increasingly taking steps to monitor their employees' use of company IT. In doing so, employers should be aware of the fact that the surveillance of electronic communication may be illegal not only under the Federal Data Protection Act but also under the German Telecommunication Act (for breach of telecommunication secrecy) and may be subject to fines and imprisonment under the German Criminal Code. In any case, a systematic and excessive monitoring of employees is prohibited under German law.

### 13.5 Data Protection Officer

It is obligatory to appoint a data protection officer where, as a rule, more than nine employees deal with automated data processing or more than 20 employees deal with non-automated data processing.

One of the general tasks of the data protection officer is to monitor and ensure that the data controller's data processing activities are in line with the provisions of the Federal Data Protection Act.

# Doing Business in Germany

# Typically German

*Germany prides itself on having the largest variety of breads worldwide. More than 300 basic kinds of bread are produced with more than 1,000 types of small bread-rolls and pastries. It has been estimated that the basic kinds of bread are so widely varied by more than 16,000 local bakeries that more than 1,000 different breads have been presented at a 2005 Cologne bread show. Germans are worldwide the biggest consumers (per capita) of bread, followed by Chile.\**

\* Texts taken from publicly available sources (Internet etc.)



## 14 REAL ESTATE

In Germany, the entire surface of the country is measured and specified on cadastral maps showing the exact location of a piece of land (i.e. its district, parcel and plot). Each individual piece of real estate is registered in the land register (*Grundbuch*) of the local court which is responsible for the district in which the real estate is located. The land register is divided into an inventory and three divisions. The inventory describes the location and size of the real estate. Division I of the land register lists the current owner, division II encumbrances and certain restrictions of the real estate, such as easements, pre-emptive purchase rights, usufruct rights, etc. other than mortgages and land charges, which are registered in division III. Unless agreed otherwise, the priority of the rights depends on their respective date of registration.

*The land register is the most important real estate register in Germany as it can allow for a bona fide acquisition of real estate. In addition to the land register and the cadastral map, there are other public registers for certain types of information, such as the register of public easements (Baulastenverzeichnis) or register of contaminated sites (Altlastenkataster).*

### 14.1 Ownership of Real Estate

*There are no restrictions under German law that apply specifically to foreign investors seeking to own real estate in Germany.*

The most common types of ownership in real estate are full title, condominiums and hereditary building rights. Depending on the specific type of ownership, the owner of real estate is generally entitled to possess and use the real estate exclusively for an unlimited period of time.

The strongest form of property ownership is full title. The ownership is not limited to the relevant plot of land, but also comprises structural parts of such land (*wesentliche Grundstücksbestandteile*), such as the buildings erected on it.

Ownership under the Co-owner Condominium Act (*Wohnungseigentumsgesetz*) provides for co-ownership in the land and all commonly used areas thereon combined with special property (*Sondereigentum*) in exclusively used areas such as condominiums. Condominium ownership is established by a partitioning plan (*Teilungserklärung*) which is filed with the land register. Condominium ownership can only be established for the entire parcel of land on which the partitioned buildings are located. The Co-owner Condominium Act provides a set of rules to organise the relationship between the co-owners and to settle potential conflicts.

A hereditary building right is a real estate-like right, i.e. a transferable and heritable right of the holder to build on land owned by a third party. In general, any sale or encumbrance (e.g. with land charges) of the hereditary building right requires the consent of the owner who, at the end of the (often 50 to 99 years) term of the hereditary building right, must compensate the holder for the value of any buildings erected on that land.

## **14.2 Acquisition of Real Estate**

The substantive and procedural law applicable to the acquisition of real estate is contained in various German laws, in particular the German Civil Code (*BGB*), the German Hereditary Building Right Act (*Erbbaurechtsgesetz*), the German Land Register Act (*GBO*), and the German Notarial Recording Act (*BeurkG*).

### **14.2.1 Notarial Sale and Purchase Agreement**

All undertakings relating to the sale and transfer of real estate governed by German law must be notarially recorded. This requirement applies to all aspects of and understandings in connection with the sale, including letters of intent providing for transfer obligations, or side agreements.

The deed must be recorded by a notary who acts as independent, impartial and objective adviser to all parties to a transaction. Under certain circumstances, the notarization can also be conducted by a non-German notary. Any non-compliance with the notarization requirement results, in principle, in the invalidity of the entire transaction. In certain situations, an invalid transaction may subsequently become legally effective with the registration of the change of ownership in the land register.

### 14.2.2 Transfer of Legal Title – Conveyance of Title

Ownership of real estate is transferred by both parties declaring the conveyance of title (*Auflassung*) and registering the transfer with the land register. The conveyance of title always requires notarization by a German notary. In practice, the conveyance of title is usually included in the same notarial deed as the sale and purchase agreement. The notary takes care of registering the transfer after the purchase price has been paid.

### 14.2.3 Acquisition Costs

Acquisition costs are all costs not included in the purchase price for the real estate, including notary fees, court fees, real estate transfer tax, finder's fees for real estate agents, the financing costs, etc. Broadly speaking, the acquisition costs increase with the value of the transaction. The value of the transaction usually equals the purchase price. For relatively low purchase prices the acquisition costs can easily amount to up to 10% of the purchase price – a percentage which can be reduced significantly for higher purchase prices.

### 14.2.4 Real Estate Transfer Tax

The purchase of real estate triggers Real Estate Transfer Tax (RETT). The current standard RETT rate is (i) 3.5% in Bavaria, and Saxony, (ii) 4.5% in Hamburg (iii) 5.0% in Brandenburg, Baden-Württemberg, Lower Saxony, Mecklenburg-Western Pomerania, Rhineland-Palatinate, Saxony-Anhalt and Thuringia, (iv) 6% in Berlin, Hessen, and (v) 6.5% in North Rhine-Westphalia, Saarland and Schleswig-Holstein of the purchase price. For further details, please see Section 5.7.



## 14.2.5 Real Estate Investment Trust

In 2007, the German Real Estate Investment Trust Act (REIT Act) introduced German Real Estate Investment Trusts (REIT *Aktiengesellschaft*), so-called G-REITs.

By creating a new indirect real estate investment listing vehicle, Germany intended to expand the potential of the German capital market and to boost Germany as an investment location. Due to the tax exemption at the REIT corporation level, the REIT regime has advantages in comparison to other investment vehicles. The REIT Act creates an incentive for selling real estate to a G-REIT by introducing tax privileges for the disclosure of unrealized reserves. As it is the case that in Germany, real estate owned by corporations comprises around 73% of the business property market (which is a relatively high percentage in comparison to other countries), the REIT Act is expected to free such immobilized capital and create liquidity to facilitate new investment in a corporation's core business.

## 14.3 Real Estate Liability

Real estate liability may result not only from encumbrances registered in the land register such as land charges, mortgages and certain other registered charges, but also from public burdens on the real estate. Such public burdens do not require registration in the land register and include, inter alia, property tax, development charges, settlement contributions for remediation and development measures and other obligations under the German Building Code (*BauGB*), or the acts of the Federal States on municipal charges entitling public authorities to share costs for infrastructural development with owners of the real estate adjacent to the relevant facility / measure.

## 14.4 Real Estate Leases

Depending on the specific type of lease, a property owner (landlord or lessor) may grant to another party (tenant or lessee) the right to use and possess a real property (or certain areas thereof) for a specified or unlimited time against payment of rent.

German lease law mainly follows from the German Civil Code, the German Operating Costs Ordinance (*BetrKVO*) governing service charges and the German Price Clause Ordinance (*PrKV*) governing the effectiveness of indexation clauses.

Lease agreements with a term of more than one year must be concluded in one single document and must comply with certain written form requirements. If a lease agreement does not comply with these written form requirements, it may be terminated in accordance with the statutory notice provisions regardless of any agreed fixed term. Pursuant to the statutory notice provisions, a commercial lease agreement may be terminated with effect as of the end of each calendar quarter by giving notice at the latest on the third business day of the preceding calendar quarter.

As a general rule, the content of lease agreements is largely negotiable between the parties. German lease law does, however, provide for certain restrictions, in particular for residential leases, which are mandatory and cannot be excluded by the parties. The purpose of most of these restrictions is to ensure a minimum level of tenant protection (e.g. regarding fixed lease terms or the limitation of termination rights). Further restrictions may apply, if and to the extent that provisions in lease agreements qualify as general terms and conditions which are subject to particular scrutiny under German law (see Section 8.3 above).

*Frequently used standard clauses such as decorative repair obligations of the tenant at fixed intervals are often held invalid by German courts due to their qualification as invalid general terms and conditions. Standard lease agreements governed by German law should therefore be regularly reviewed to ensure their compliance with recent case law.*

If real estate is sold, lease agreements entered into between the property owner and tenants are generally transferred to the new owner by operation of law. The same applies *mutatis mutandis* to lease agreements that the current owner assumed by operation of law from the previous owner.

## 14.5 Construction of Sites

The construction of sites is governed by public construction law consisting of planning law and building law.

### 14.5.1 Planning Law

Planning law sets forth the legal framework for municipal land planning through zoning plans (*Flächennutzungspläne*) and building plans (*Bebauungspläne*) and determines whether a construction project is permissible under the applicable local planning law. While the zoning plan constitutes the basic guideline for land use within a community and is only binding upon the planning authorities, the building plan determines the utilization of the land it is issued for, i.e. defines whether land may be used as residential area, commercial area, mixed zone or other type of area, and designates the type of buildings permissible in such area.

For large construction projects, the issuance of a building plan is obligatory. Investors may apply for a project-related building plan. Such plan will determine the permissibility of a project with regard to planning law; it can be issued if the investor: (i) is prepared to execute the project and necessary site development measures in accordance with a project and site development plan developed in consultation with the community; and (ii) enters into an implementation agreement with the community under which he commits to realize the project within a fixed time limit and to bear the costs for planning and site development.

### 14.5.2 Building Law

Building law is subject to the legislation of the Federal States which have each enacted a Building Code (*Bauordnung*). The Building Codes aim to prevent possible dangers in connection with the construction of a building by establishing certain technical standards which must be adhered to. These standards include, for example, rules on the stability of buildings, fire safety, heat insulation, building materials and the minimum distance between adjacent buildings.

*The Building Codes also set out the conditions for obtaining a building permit and provide for the corresponding application procedure.*

### 14.5.3 Permits for Construction

Except for certain small projects, the construction of a building or plant is subject to governmental authorization. This authorization can either be granted in the form of a separate building permit or as part of an immission control permit issued under the Federal Immission Control Act (*Bundes-Immissionsschutzgesetz*).

### 14.5.4 Separate Building Permit

A building permit is required for the construction of a new building as well as for major developments to or the change of use of existing premises. Following a written application process, the building permit will be granted by the local authorities if the envisaged project complies with local planning law and the technical standards specified by building law. In addition, the project may not conflict with any other requirements established under public law (e.g. monument protection law or emission limits pertaining to the project).

#### 14.5.5 Immission Control Permit Issued under the Federal Immission Control Act

The construction and operation of installations which are likely to cause harmful effects on the environment because of their emissions are specifically regulated in the German Federal Immission Control Act. If a permit under the Federal Immission Control Act is issued, no separate building permit is required. For certain facilities – e.g. power plants, combustion plants or wind farms – an immission control permit must be obtained in order to erect and operate such an installation.

# Doing Business in Germany

# Typically German

**SchwarzwälderKirsch Torte**, Black Forest gateau, is a cream cake, which has grown in popularity since the 1930s, especially in Germany. Today it is regarded as the classic German cake and is renowned around the world.\*

\* Texts taken from publicly available sources (Internet etc.)



## 15 ENVIRONMENTAL LAW

While operating a site, environmental law requirements must be carefully observed. These include, inter alia, legal requirements regarding water and air pollution, noise emissions, waste prevention, recycling and disposal, nature protection, use of hazardous substances and energy efficiency.

Where environmental damage is caused, the site operator and the land owner can be held liable. In addition to site-specific environmental requirements, mandatory requirements also apply to the environmental performance of finished products and materials. Only products that meet applicable environmental performance standards may be placed on the European Union market.

### 15.1 Air and Noise Emissions

The German Federal Immission Control Act (*Bundes-Immissionsschutzgesetz*) is the most important piece of legislation regulating emissions from industrial sites. It applies to all the kinds of installations which are enumerated in an ordinance to the act. The Federal Immission Control Act limits all kinds of emissions emanating from an industrial site, including air emissions, noise and odour.

Facilities which are not listed in said ordinance do not require a permit under the Federal Immission Control Act, but may be subject to specific obligations or require special permits (e.g. pipelines or storage facilities for inflammable liquids, pressure tanks or steam boilers). In addition, facilities which do not require a permit under the Federal Immission Control Act do require a building permit. Such building permit will only be granted if the facility is in compliance with applicable zoning and construction requirements and other regulatory requirements, including fire protection standards (see Section 14.5).

The comprehensive procedure for obtaining a permit under the Federal Immission Control Act consists of the following steps:

- Filing an application with the competent authority. The application shall include certain documents, which must enable the competent authority to



assess whether all of the conditions for issuing an operating permit are met. For certain installations which are considered having a major impact on the environment, an environmental impact assessment has to be filed with the competent authority. Such assessment describes the predictable impacts of the facility on the local environment, including an analysis of the initial state of the site, an evaluation of natural and sanitary risks and specific sections on flora and fauna, air, water, noise and waste.

- In certain cases, the project is then subject to a public consultation for a certain period, during which interested parties may make comments.
- The authorization must be issued within seven months, in simplified procedures within a period of three months, following the submission of the complete set of documents to the competent authority. In difficult cases, the competent authority may extend this period by three months.

The initial operating permit may contain conditions the applicant needs to observe, if such conditions are required to ensure that the facility will be built and operated in compliance with law.

The relocation, modification or change of use of a classified facility must be notified to the environmental authority. In case of a material deviation from the existing permit a new operating permit will be required.

All facilities can be subject to on-site inspections, carried out by the environmental authorities. If a facility does not comply with all applicable requirements or if a facility is erected or operated without the required operating permit, environmental authorities may order the operator to implement any measures necessary to achieve compliance, which may include, in serious cases, the temporary or permanent shutdown of the facility as well as administrative sanctions.

Limits for CO<sub>2</sub> emissions are set by the emission trading scheme established in the European Union for reducing the emission of climate-damaging greenhouse gases. Under this scheme, energy-intensive industries such as steelworks, refineries and cement works must deliver emission allowances to the authorities to offset their greenhouse gas emissions. These emission allowances are

tradable and companies may purchase emission allowances from third parties in order to meet their respective obligations vis-à-vis the authorities. Companies that cannot deliver sufficient allowances in time must pay a penalty of EUR 100 per ton of carbon dioxide equivalent, in addition to the unpaid allowances.

## 15.2 Water and Waste Water

A facility operator may:

- Withdraw water from the municipal system;
- Withdraw water from surface waters and watercourses; and
- Withdraw groundwater.

However, withdrawing water from surface waters and watercourses as well as withdrawing groundwater requires a permit under water legislation. Such permit will specify the amount of water which may be withdrawn as well as the method by which water may be withdrawn, and can be subject to further conditions.

The discharge of waste water into surface water requires a water discharge permit. Such permit will only be granted if the discharged water is sufficiently clean. Specific thresholds apply, depending on the type of industry generating the waste water. In order to bring the waste water to acceptable levels of cleanliness, the operation of a waste water treatment installation may become necessary, for which also a permit is required. In addition, the generator of waste water, which is discharged directly into surface or groundwater, is obliged to pay an annual charge.

Waste water is often not discharged into surface waters, but into the public sewage system, in which case local by-laws apply, setting maximum pollutant loads.

## 15.3 Waste

Waste is defined as "any substance or object which the holder discards or intends or is required to discard". The two main categories of waste are:

- Hazardous waste, that is waste with hazardous properties, such as explosive, oxidizing, highly flammable, harmful, toxic and infectious substances; and
- Non-hazardous waste.

Aside from these two types, special legislation applies to specific kinds of waste which require particular treatment, such as waste oils, refrigerants, sewage sludge, asbestos waste, radioactive waste, etc.

The primary concern of the German waste laws is the avoidance of industrial and commercial waste. Facility operators are responsible for the waste they produce and they must avoid generating waste. Waste which cannot be avoided must be reused. Only if it is not possible to reuse waste, it may be recycled in an environmentally acceptable way. Only if it is not possible to recycle the materials, it is allowed to be used as fuel, e.g. in a power plant. Waste which can neither be avoided nor recycled may be disposed of in accordance with the procedures set forth under the German waste laws.

In addition, particular take-back and recycling requirements apply to certain kinds of waste, e.g. packaging material, used cars, batteries, used wood, used oil, electrical and electronic equipment.

## **15.4 Liability for Environmental Contamination**

The site operator and the land owner are liable for environmental contamination, both under administrative and / or civil law.

### **15.4.1 Administrative Law Liability**

The competent authority may demand remedial action to be taken (i) by any person causing a danger to public goods (including the environment), even if such person acted without fault, or (ii) from the owner of the specific good or real estate from which the danger emanates. This general liability is complemented by special provisions establishing liability for soil contamination and environmental damage.

According to the German Federal Soil Protection Act (*Bundes-Bodenschutzgesetz*), the polluter, its legal successor, the owner and / or occupier of real estate are obliged to investigate and clean up soil and water contamination. Under certain conditions, the former owners of real estate may also be held liable. Whether or not remedial action is required will be determined by the competent authorities on the basis of various factors, including the level of contamination, the current and / or future use of the land, and the hazards the contamination poses to water, especially groundwater. The authorities will also determine which person must carry out remedial action. They may opt for the person that can cure the damage most efficiently.

With regard to environmental damage caused after April 30, 2007, the German Environmental Damage Act (*Umweltschadensgesetz*) establishes certain obligations to inform, prevent and remedy damage to species and natural habitats, provided such damage has been caused or is being caused willfully or negligently by professional activities of any kind. In addition, the Environmental Damage Act provides for strict liability for any damage to the environment which has been caused or is being caused by certain professional activities, such as the operation of installations requiring a permit under the clean air act, nuclear installations, pipelines, etc.

### 15.4.2 Civil Law Liability

Any individual or legal entity is liable for environmental damage to the extent such environmental damage constitutes an injury to life, body, health, freedom, property or other right of another person, and provided that such injury is unlawful and was caused willfully or negligently. Strict liability is established for damage resulting from the contamination of surface, coastal and ground waters, and for damage caused by environmental effects emanating from certain environmentally hazardous installations (e.g. power plants, combustion plants or chemical plants).

## 15.5 Product-related Environmental Compliance

The environmental performance of products is also regulated. Such product-related environmental regulation comprises, inter alia, restrictions on the substances that may be used to manufacture a product, restrictions on the

amount of emissions that a product generates and the amount of energy such product consumes as well as requirements for managing the end-of-life stage of a product.

Products may not be placed on the market, if they contain substances which pose hazards to the environment or human health. For example: furniture containing substantial amounts of formaldehyde, electronic goods containing lead or toys containing certain phthalates are all prohibited and may not be placed on the market. Chemicals are comprehensively regulated by the Regulation on Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) and by the Regulation on Classification, Labeling and Packaging of Substances and Mixtures (CLP). Under REACH, the use of certain hazardous substances in products requires authorization from the European Commission. Such authorization will only be granted, if the risk to human health or the environment arising from the use of such substance is adequately controlled, or if the overall benefits of using a product outweigh the risk to human health or the environment, provided that no suitable alternative is available.

The environmental performance of a product is also subject to certain restrictions e.g. with respect to the generation of noise, exhaust gases and certain pollutants. In addition, numerous regulations exist with regard to the end-of-life treatment of used products, for instance, take-back schemes have been established for certain product groups including packaging, vehicles, batteries and electronics.

Finally, minimum standards apply with regard to the energy efficiency of various types of "energy-related products", such as air conditioning systems, heating equipment, cooking equipment, machine tools, electric motors etc. Such products may only be placed on the European Union market if they meet the minimum performance standards established by law.

# Doing Business in Germany

# Typically German

**Deutsche Eiche** (*The German oak*)  
is the national tree of Germany, thus  
oak leaves are a prominent symbol  
on most German military orders.

An oak leaf is displayed on some  
German coins, both of the former  
*Deutsche Mark* and the current *EUR* \*

\* Texts taken from publicly available sources (Internet etc.)



## 16 LIABILITY

When conducting a business, each entrepreneur faces liability risks. In order to manage these risks effectively, it is important to know when (and to what extent) liability will be triggered. The legal regime of liability under German law depends on whether liability is based on contract law or tort law. Under both regimes, as a general rule, the party causing the damage is liable only if it acted negligently or intentionally. In principle, any direct and indirect damages caused by the injuring act are recoverable. In addition, the German legal system draws a distinction between personal liability and liability based on property rights.

### 16.1 Contractual Liability

#### 16.1.1 Main and Ancillary Obligations

When parties enter into a contract, they establish a system of (usually mutual) obligations. Those obligations are divided into the main obligations, which characterize the individual type of contract, and ancillary obligations, which are meant to protect the other party and to support the proper performance of the main obligations.

*The obligations under a sales contract to deliver the goods and to pay the purchase price are the main obligations whereas the obligation to provide the buyer with a proper invoice is an ancillary obligation.*

Irrespective of the nature of a contractual obligation, a party that breaches its contractual obligations can be held liable under the German Civil Code.

If a main obligation is breached, the other party is entitled to rescind the contract and claim damages for non-performance of the contract. From an economic point of view, the other party is to be put in the position it would have been in had the contract been properly performed.

If ancillary obligations are breached, the other party is entitled to claim any damages caused, but the contract will remain unaffected.



*If a retailer cannot fulfill its obligations towards its customer because its supplier has not delivered the goods as promised (i.e. has not fulfilled its main obligation), the supplier has to put the retailer into the position the retailer would have been in had the supplier delivered, i. e. the supplier will be liable for lost profits, the cost of buying products from other suppliers because it failed to deliver those products, or damages claimed by the retailer's customers.*

The scope of the relevant obligations will be established on a case by case basis, and depends on the individual contract.

### 16.1.2 Pre-Contractual Liability

The contractual liability regime protects the parties to a contract even prior to entering into the actual contract. In the pre-contractual phase, the parties are obligated to protect the other party's rights or (legal) interests. Liability in the pre-contractual phase starts with the initiation of a contract where one party gives the other party the possibility of affecting its rights or (legal) interests. If a party breaches its pre-contractual obligations, it will be held liable under the contractual liability regime. The pre-contractual liability requires negligent or intentional conduct.

*If the parties have negotiated a contract, come to mutually acceptable terms, and agreed that they will enter into the contract, such that the only thing missing is the parties' signatures, neither party can walk away from the contract without a justified reason. Walking away without a justified reason would trigger liability for breach of the other party's justified expectation that the contract would be signed by the other party. That means that the other party is reimbursed for its costs incurred for the contract negotiations, but it cannot claim damages for non-performance.*

### 16.1.3 Protection of Third Parties Under Contractual Liability Regime

Agreements may give a third party a direct contractual claim against one of the parties to the contract. A third party can be included in the scope of a contract as a beneficiary of it without being a party to it (or even being aware that it is a

beneficiary). German courts extended this concept of contractual protection so that third parties may also seek recourse under a contract even when they have not explicitly been named as beneficiary.

The third party will be protected if it is foreseeable for the other party that: (i) the third party will be affected by the due execution of the contract in the same manner as the parties to the contract; (ii) one of the contracting parties has a specific interest in including the third party in the scope of the contract; and (iii) the third party is (legally) in need of protection.

*An expert providing an assessment or opinion (e. g. on the value of real property) has to assume that this assessment will be shown to third parties (e. g. the financing bank). Therefore, the expert is also liable towards these third parties in the same manner as towards the other party to the contract, unless the liability is explicitly excluded in the assessment or opinion.*

## 16.2 Non-Contractual Liability (Tort Law)

It is a peculiarity of the German legal system that the liability regime under German tort law is much more restrictive than under contract law. Under tort law, in general, only those property rights are protected which are specifically listed in the German Civil Code, e.g. life, body, property.

Tort law, however, does not protect a person's financial interests as such against pecuniary losses. Assets / property rights which are not covered by tort law are protected only under contractual liability or if a person commits fraud. Therefore, case law has been developed to extend contractual liability so that the restrictions under tort law are compensated.

*If a seller delivers a machine which contains a defective part, tort law will not apply in the event that the machine simply does not work. This would be a warranty issue only (i.e. contractual liability). If the defective part causes damage to other parts of the machine, however, such damage might be recoverable under tort law.*

### **16.3 Negligence or Intent Required**

In general, a person can be held liable only where he / she breaches his / her obligations negligently or intentionally. This applies in general to both tort law and contract law. However, under contract law it is assumed that any breach of contractual obligations has occurred at least negligently. The party breaching its obligations must demonstrate that it did not act negligently or intentionally, if it wants to avoid liability.

However, there are several exceptions to this general rule for special areas of law e.g. a manufacturer's product liability, liability of the owner of animals, cars or buildings, i.e. German law recognizes strict liability for certain areas in which an object, by itself, is a potential hazard for others.

### **16.4 Damages**

The party causing the damage must compensate the injured party for any damages suffered. Under German law, any direct and indirect damages can be recovered, but no punitive damages may be claimed.

The injured party must prove that the breach was committed by the injuring party and that the level of damages claimed were actually incurred. Only under certain circumstances can the injured party claim compensation for non-material damages (e.g. pain and suffering). Only in rare cases, a court is entitled to estimate the level of damages incurred.

Generally speaking, it is possible to limit one's liability through agreement with the other party (except for liability based on intentional behavior which cannot be limited or excluded in advance). Considerable restrictions apply, however, to limitation or exclusion of liability in general terms and conditions.

# Doing Business in Germany

# Typically German

*The **Ampelmännchen** (little traffic light man) is a beloved symbol in Eastern Germany enjoying the privileged status of being one of the few features of communist East Germany to have survived the end of the Iron Curtain with his popularity unscathed.*

*It is the symbolic person shown on traffic lights at pedestrian crossings.\**

\* Texts taken from publicly available sources (Internet etc.)



## 17 INSURANCE

Germany has a well-developed insurance market and sophisticated, well-balanced insurance legislation. In recent years, German insurance law has been strongly influenced by European Union legislation resulting in the opening up of national markets, an increased freedom of establishment and freedom to provide services for foreign insurers and intermediaries from the European Union or the European Economic Area, and a greater harmony in European-wide legislation on this topic.

The main regulatory rules are contained in the Insurance Supervisory Act (*Versicherungsaufsichtsgesetz*) and the main contractual rules in the Insurance Contract Act (*Versicherungsvertragsgesetz*).

### 17.1 Supervision of Insurance Companies

The Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*) is the main regulatory authority for insurers and re-insurers doing business in Germany. The supervisory authority carries out both legal and financial supervision; its objectives are to protect the interests of policy holders, ensure compliance with insurance laws, and monitor the financial stability of the insurers.

The supervisory authority is responsible for licensing and supervising insurers and is empowered to take any appropriate supervisory measures to prevent and eliminate any irregularity in the insurer's business. In addition to requesting information from the insurer, the authority may take steps to revoke the insurer's license, prohibit the conclusion of certain contracts, or admonish the insurer's executives. As a rule, however, the supervisory authority does not approve general insurance terms.

## 17.2 Operating an Insurance Business

Insurers require a license in order to sell insurance in Germany, be it directly or via intermediaries. However, where an insurer sells insurance purely by way of correspondence, a license may not be required. Both German insurers and non-European Union / European Economic Area insurers must apply to the supervisory authority for a license.

Something else applies to insurers located in a member state of the European Union / European Economic Area. For such insurers it is sufficient to be licensed by their competent home authorities, which are also responsible for the financial supervision. Thus, insurers located in the European Union / European Economic Area can rely on the passporting system, i.e. they generally do not have to apply for a separate license in Germany.

### 17.2.1 Requirements for Operation

German insurance companies must be incorporated as a stock corporation, a mutual society or a corporation or institution under public law. They may only sell either life insurance or non-life insurance. In order to obtain a license, insurers have to fulfill several requirements and submit various documents in relation to the professional and personal suitability of the insurer's directors and managers, the insurer's business plan and articles of association, and the insurer's financial organization, including minimum capital requirements (capital to the amount of the solvency margin, but at least EUR 2,500,000 or EUR 3,700,000 depending on the insurance class).

Foreign, Non-European Union / European Economic Area insurers are required to establish a branch in Germany and appoint an authorized agent. To obtain a license from the supervisory authority, they must submit a variety of documents regarding their operational and financial situation, including minimum capital requirements (capital to the amount of a solvency margin calculated on the basis of the branch's business, but at least EUR 1,250,000 or EUR 1,850,000 located within the European Union / European Economic Area depending on the insurance class).

Foreign European Union / European Economic Area insurers intending to do business in Germany must first inform their home authority. Depending on whether the insurer intends to operate through a branch or is simply relying on its freedom to provide services, the home authority will provide the supervisory authority with different information on the insurer including a scheme of operation and a certificate as to the minimum solvency margin.

### 17.2.2 Ongoing Operation

Once a German or non-European Union / European Economic Area insurer has established its business in Germany, the insurer is obliged to report financial information to the supervisory authority on a regular basis and to comply with the rules on financial reserves and solvency margins. Insurers are restricted as to the type, amount and location of the investments of their reserves. They are also obliged to maintain a risk management system. When selling insurance via intermediaries, insurers have to ensure that the intermediaries are duly licensed and registered.

On the contractual side, insurers in Germany must run their business in conformity with the Insurance Contract Act. This act provides a framework for the conclusion of insurance contracts, the obligations of the insurer to inform and advise the policyholder and to document such information and advice, as well as the determination of the sum to be paid upon the occurrence of an insured event.

A foreign insurer cannot simply transfer his foreign insurance products to the German market. Due to German and European conflict of law rules, the policies of foreign insurers will often have to be adapted in line with substantive German insurance contract law.



### **17.3 Distribution of Insurance Products**

In Germany, around 90% of insurance contracts are sold through intermediaries, be they agents, brokers or banks. The majority of insurance intermediaries act as agents for a single insurance company.

Insurance intermediaries doing business in Germany generally require a license from and have to be registered with their local Chamber of Commerce (the register can be accessed online at [www.vermittlerregister.info](http://www.vermittlerregister.info)). In order to obtain a license, the insurance intermediaries must provide evidence of good reputation, financial capacity, sufficient professional qualification, and special professional indemnity insurance. For foreign European Union / European Economic Area insurance intermediaries, freedom of establishment and services is warranted.

Insurance intermediaries have extensive obligations to inform and advise the policyholder in relation to their business and the products sold and to document such advice. The ongoing supervision of insurance intermediaries is performed by the local Chamber of Commerce and the local Trade Supervisory Office.

### **17.4 Buying Insurance**

Companies doing business in Germany will usually have some compulsory insurance policies and also some voluntary insurance policies. When a company is part of a foreign group, the company may be covered by the policy of its foreign parent company. However, differences in the terms of the policies regarding liability and conditions should be considered in light of the need to adapt insurance coverage in line with local laws.

The clauses relating to the scope of the insurance coverage, its exclusions and limitations, the breach of contractual duties, deductibles and underinsurance are particularly important. Although insurers largely rely on general policy conditions, business policies usually also contain certain individual stipulations which may differ significantly between insurers and also between policies.

Where an insured event occurs, the policyholder must inform its insurer without undue delay. If the policyholder caused injury to a third party, the liability insurer has the right and the duty to manage the defense proceedings. If the insurer remunerates the policyholder, the insurer, in most cases, automatically acquires any claims of the policyholder against another party, who may be held responsible for the injury.

### 17.4.1 Compulsory Insurance

German law provides for a variety of compulsory insurance, in particular in the field of professional indemnity, such as for notaries, lawyers or (in many regions) architects, but also for motor vehicles or commercial freight haulage.

### 17.4.2 Voluntary Insurance

In addition, when doing business in Germany, companies usually have insurance coverage for risks resulting from their business. The most common insurance policies are manufacturer's or general liability insurance, including, if applicable, product and / or environmental liability insurance, as well as fire and business interruption insurance.

Further, D&O insurance policies are becoming more and more common in Germany. Their policy conditions, however, need to be carefully reviewed to ensure sufficient coverage under the German legal system.

Other insurance policies which may be of interest depending on the type of business conducted are: IT-insurance; transportation insurance; trade credit insurance; and construction insurance.

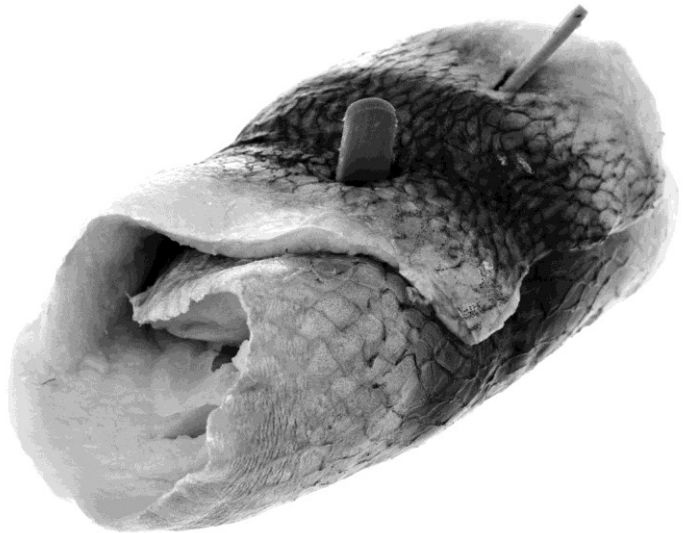


# Doing Business in Germany

# Typically German

**Rollmops** (pickled herring) grew popular throughout Germany during the Biedermeier period of the early 19th century and became known as a particular specialty of Berlin, like the similar pickled herring dish Bismarckhering. In former times, it was common in Berlin pubs to have a high-rising glass display cases (Hungerturm, meaning "hunger tower") on the bar to present ready-to-eat dishes like lard bread, salt eggs, meatballs and of course Rollmops.\*

\* Texts taken from publicly available sources (Internet etc.)



## 18 DISPUTE RESOLUTION

Germany has a civil law legal system, inspired by Roman law. The law in Germany is codified and – in contrast to common law – not determined by judges. Since legislation is the primary source of law, the legal concept of precedent is unknown. In general, courts are not bound by previous decisions of higher courts, and judgments have a binding effect only between the parties to the relevant proceedings. In practice however, lower courts and even arbitral tribunals usually apply the case law developed by the higher courts, thereby ensuring that the law is interpreted and applied homogeneously.

### 18.1 The German Judicial System

Germany has both ordinary courts, and specialized courts for employment, social security, tax matters, and administrative law. In total, Germany has five federal courts and one Federal Constitutional Court. The diverse jurisdictions have been established to guarantee a high quality of jurisprudence, even where specialized areas of law are involved. The competence of a court depends on the relevant area of law and / or the circumstances of the particular case (e.g. the amount or subject matter in dispute). The Federal Constitutional Court (*Bundesverfassungsgericht*) is not an integral stage of judicial or appeals process. The Federal Constitutional Court is permitted to determine only constitutional questions. Regular courts, parliaments and even individuals, among others, are entitled to submit cases for review to the Federal Constitutional Court. However, the Federal Constitutional Court Act, which governs the procedure, strictly restricts the cases the court hears.

#### 18.1.1 The Ordinary Courts

The German ordinary courts are subdivided into civil and penal jurisdiction. The courts of the civil jurisdiction are authorized to hear any case relating to private law (including commercial and family cases) that is not assigned to a specialized court. Criminal cases, on the other hand, are heard before separate courts belonging to the penal jurisdiction.

The ordinary courts – for the civil as well as the penal jurisdiction – are further divided into several instances. The Local Court (*Amtsgericht*) serves as the primary court of first instance for small cases with an amount in dispute not exceeding EUR 5,000. The Regional Court (*Landgericht*) is both a court of first instance and the appellate court for decisions of the Local Courts. In first instance, the Regional Court is competent for civil cases falling outside the jurisdiction of the Local Court (e.g. cases exceeding an amount in dispute of EUR 5,000). Usually cases are tried in front of a single judge. In complex cases before the Regional Court, however, the single judge may (and usually does) refer the case to a panel of three judges. In specific commercial cases, each party is entitled to refer the dispute to a specialized chamber of the Regional Court (*Kammer für Handelssachen*). Such commercial cases are tried in front of a panel of three judges, of which one judge is a judge by profession, and the other two judges are lay judges, usually executives of small companies within the district of the Regional Court. Each party must be represented by a lawyer before the Regional Court.

The Higher Regional Court (*Oberlandesgericht*) is an appellate court which hears appeals against judgments of the Regional Court. In special cases (e.g. concerning the recognition and enforcement of foreign arbitral awards), the Higher Regional Court acts as a first instance court. Before the Higher Regional Court, each party must be represented by a lawyer.

The Federal Court of Justice (*Bundesgerichtshof*) is the highest court in civil and criminal matters. It is seated in Karlsruhe and is divided into 25 senates. Only a limited number of lawyers are admitted to appear before the Federal Court of Justice. In practice, cases are handled by both the attorney of the first and second instance together with an attorney admitted to appear before the Federal Court of Justice. The Federal Court of Justice hears appeals only on questions of law. Since the Federal Constitutional Court is not an integral stage of the appeals process, a losing party may not seek further legal protection from it.

### 18.1.2 Specialized Courts

In addition to the civil jurisdiction appertaining to the ordinary courts, Germany has established several specialized courts to guarantee a high quality of jurisprudence even in complicated and specific areas of law.

- The Labor Courts are authorized to hear both individual labor law (mostly concerning contracts of employment) and collective labor law cases (e.g. cases concerning labor disputes and collective bargaining). The court of first instance is the State Labor Court (*Arbeitsgericht*), the appellate court is the Superior State Labor Court (*Landesarbeitsgericht*). The highest court is the Federal Labor Court (*Bundesarbeitsgericht*) having its seat in Erfurt.
- The Social Courts hear cases on social security issues, which mainly relate to public health insurance, pension insurance and issues regarding social welfare. There are three levels: the Social Courts (*Sozialgerichte*), the Superior State Social Court (*Landessozialgericht*) and the Federal Social Court (*Bundessozialgericht*). The Federal Social Court is seated in the city of Kassel.
- Cases relating to tax and customs law issues are heard before the State Fiscal Courts (*Finanzgerichte*). After the first instance court, there is only the Federal Fiscal Court (*Bundesfinanzhof*) available. The Federal Fiscal Court is seated in Munich.
- Within the Administrative Courts, there are up to three levels depending on the subject matter of the individual case. In principle, all cases relating to administrative law are heard before the Administrative Courts (*Verwaltungsgerichte*). The Superior Administrative Courts (*Oberverswaltungsgericht* or *Verwaltungsgerichtshof*) hear appeals against decisions of the Administrative Courts. The Federal Administrative Court (*Bundesverwaltungsgericht*) is generally the federal court for appeals in all cases involving administrative law. The Federal Administrative Court is seated in Leipzig.

### 18.1.3 International Jurisdiction of German Courts

The jurisdiction of German courts in international cases is mainly determined by European law and public international law. From a German legal perspective, the provisions concerning territorial jurisdiction of German courts also comprise the courts' international jurisdiction. Jurisdiction of German courts can be based



either on the agreement made between the parties or can be established by reference to general provisions of the German Code of Civil Procedure. For example, a German court will be authorized to decide a case if: the defendant is domiciled or seated in its district; or if the contractual place of performance is within its district; or if the assets of one party are located within the court's district. In the latter case, however, a certain relationship to Germany must be established.

For cases against a respondent from Europe, the jurisdiction of German courts is determined by the European Union Council regulation (EC) No. 44 / 2001, recent recast by the regulation (EU) No 1215 / 2012.

## **18.2 Course of Proceedings**

### **18.2.1 Initiating Legal Proceedings**

A party commences legal proceedings by filing a statement of claim with the applicable court. In its statement of claim, the claimant must precisely identify the relief sought and must explain the facts supporting its claim.

When filing a statement of claim, the claimant must pay a court fee for the first instance proceedings. The amount of the court fee depends on the value of the matter in dispute. Once the claimant has paid, the court will serve a copy of the statement of claim to the respondent. Only then, the dispute becomes pending.

The respondent then has two weeks to notify the court that it wishes to defend itself. Additionally, the judge usually sets a deadline for the respondent to submit a statement of defense. This will then normally be followed by another round of statements. The judge, however, is also free to immediately schedule a date for a first court hearing or to give the parties the opportunity to file additional statements.

### **18.2.2 Course of the Proceedings**

In general, it is mandatory to have at least one court hearing. However, depending on the complexity of the case and the number of witnesses and expert witnesses, judges are free to hold several hearings. In practice, the

proceedings are focused on written submissions in which the attorneys are expected to present all of the details to the case. In the oral hearing, the attorneys simply refer to their written submissions and do not deliver lengthy oral pleadings. Only in complex cases will the judge discuss aspects of the case with the parties in the oral hearing.

### 18.2.3 Taking of Evidence

If one party contests the other party's factual assertions and if the other party bears the burden of proof, the other party must identify the evidence it relies upon, i.e. it must submit the respective pieces of evidence to the court and / or offer witness testimony.

In civil proceedings, evidence may be presented by documents, witnesses, expert opinions and judicial inspection of properties or assets. Under limited preconditions, the taking of evidence may involve the examination of a party. In general, however, the parties to the court proceedings (including managing directors and members of the board of directors) cannot be heard as witnesses.

It is typical in German court proceedings for the judge to play an active role in the proceedings and to take evidence. There is no US-style cross examination of witnesses. Only after the judge has addressed his or her questions to the witness or expert witness, the parties (through their attorneys) may be permitted to ask additional questions.

German civil procedure does not provide for disclosure. Requests for document production, or discovery proceedings as they are known in common law jurisdictions, do not exist under German law and are, in fact, inadmissible. Only under specific circumstances a party can request the production of a specific document it relies upon in its case.

### 18.2.4 Costs of the Proceedings

Litigation costs consist of court fees and court expenses (e.g. for witnesses or expert witnesses) as well as attorneys' fees. The losing party must bear all costs of the proceedings, including the winning parties legal fees. If a party is successful only in part, the costs will be split proportionately between the

parties. The level of legal fees that can be recovered from the losing party, however, is limited by statute and depends both on the value of the amount in dispute and the different courts involved in resolving the dispute.

### 18.2.5 Duration of the Proceedings

The duration of legal proceedings depends on the individual case and the approach taken by the judge. As a guideline, first and second instance proceedings normally each take between six to 12 months each, while proceedings at the Federal Court of Justice normally take 12 to 18 months. In complex cases, it is not unusual for each stage of the proceedings to take more than one year, especially if expert witnesses are involved.

### 18.2.6 Amicable Settlement

In contrast to many other jurisdictions, the German Code of Civil Procedure explicitly supports amicable settlements. Therefore, before entering into the oral hearing, the judge is obligated by law to try to get the parties to reach an amicable settlement. Only if a settlement fails, the court will enter into the first oral hearing. Even in such case, however, the court is called upon to support amicable settlement discussions throughout the entire proceedings.

Such a conciliation hearing does not have to take place if an independent conciliation authority (e.g. a mediator) has already unsuccessfully attempted to settle the dispute or if an amicable settlement is clearly pointless.

## 18.3 Challenging Judgments

The German Code of Civil Procedure recognizes in principle two appeals: a first appeal and a second appeal.

### 18.3.1 First Appeal

Generally, a party may file a first appeal if the first instance judgment deviates from the relief sought by the party. The party filing the appeal can justify the appeal only by arguing that the lower court made an error of law or an obvious error of fact. Only in exceptional circumstances will the parties be allowed to introduce new facts during the appellate proceedings.

### 18.3.2 Second Appeal – Limited to Questions of Law

A second appeal to the Federal Court of Justice is admissible if permission is given by the Appellate Court or if the Federal Court of Justice accepts the second appeal on the basis that the matter is of general importance or the appeal is necessary to develop a uniform application of the law. The appellant is entitled to raise only questions of law; the facts ascertained by the lower courts are binding.

## 18.4 Specific Proceedings

### 18.4.1 Documentary Proceedings

If a claimant is in a position to prove its claim by the mere use of documentary evidence (such as a check or a written contract), he may opt for a summary procedure based on documentary evidence (*Urkundenprozess*). In such proceedings, no witness or expert evidence will be admitted. As a result, a judgment can be obtained within a shorter period of time. The summary judgment will be enforceable without having to provide security. The respondent, may appeal against the court's decision. In the subsequent proceedings, all conventional means of evidence are admissible.

### 18.4.2 Summary Proceedings

A claimant may pursue a payment claim in summary proceedings (*gerichtliches Mahnverfahren*) by filing a respective application for a payment order with the Local Court. If the relevant formal requirements are met, a court officer (*Rechtspfleger*) will grant the payment order. After the payment order has been served, the debtor has a period of two weeks to object to the payment order. If the debtor does not object, the creditor may apply for an enforceable execution order. After service of this execution order, the debtor has another two weeks to file an objection with the court. If the debtor does so, the proceedings continue as normal civil proceedings. If the debtor does not object, the execution order ultimately becomes binding and may be enforced.

Summary proceedings usually are considered only if the debtor is not expected to defend the claim or if the expiry of a limitation period needs to be urgently suspended.

### 18.4.3 Interim Proceedings

German law offers two forms of preliminary relief which will be granted only in exceptional cases:

- Preliminary injunction requiring / preventing certain action until the party's rights have been finally determined; and
- Attachment order preventing removal or dissipation of the defendant's assets if there is evidence of an intention to remove or conceal those assets.

Proceedings for both forms of preliminary relief essentially follow the same rules. To obtain interim relief, the applicant must submit prima facie evidence by way of documentation and / or detailed affidavits that it has a justified claim against the respondent and that the applicant urgently needs interim relief. The applicant must explain why the enforcement of its claim would be endangered without the preliminary relief being granted. In very urgent cases, the court may decide to render its decision *ex parte*, i.e. without notice and without giving the respondent an opportunity to be heard. The respondent may object to the court's order and request an oral hearing after which the court may change its order. If the court grants the injunction or attachment order, the applicant must seek to enforce the order within one month.

If the interim order is enforced but then lifted on appeal or if the main proceedings show that the applicant does not have a valid claim, the applicant will be held liable by the respondent for any damages caused and costs incurred.

### 18.4.4 Default Judgment

If a party does not appear in a court hearing, the court will issue a default judgment upon application of the other party. Such judgment is immediately enforceable.

The party in default may file an objection against the default judgment with the court that issued the judgment. In its objection the party does not have to state specific reasons, but the oral hearing will continue upon such objection.

If the party in default fails to appear in the following hearing, the default judgment will ultimately become final and binding.

## 18.5 Enforcement Proceedings

### 18.5.1 Enforcement of German Judgments

Enforcement proceedings depend on the nature of the claim to be enforced.

- Payment claims can be enforced as follows: (1) In relation to movable assets, the judgment creditor can ask the court bailiff (*Gerichtsvollzieher*) to seize the assets, which will then be sold at a public auction. (2) A judgment creditor can also seek an order of the court requiring a third party debtor to pay to the judgment creditor any sum the third party debtor owes the judgment debtor. (3) Enforcement of judgments relating to real property require different proceedings. There are three main methods of enforcement against real property owned by the judgment debtor. The judgment creditor may (i) enter a mortgage in the land register, (ii) effect an execution sale or (iii) apply for the administration of the property through an administrator appointed by the court to satisfy the claim through the rents and profits of the property.
- If the judgment creditor seeks enforcement of judgments through delivery of goods, the court bailiff will seize those assets and deliver them to the judgment creditor.
- If specific performance is owed and if that performance can be made by a third party, the court may authorize the judgment creditor to have a third party perform the act at the cost of the judgment debtor. If the relevant act / omission can be performed only by the judgment debtor, the court will (upon application by the judgment creditor) impose a penalty of up to EUR 250,000 or alternatively a prison term of up to two years on the judgment debtor if it fails to fulfill its duty to perform under the judgment.

## 18.5.2 Recognition and Enforcement of Foreign Judgments

Frequently, the recognition and enforcement of foreign judgments follows multilateral or bilateral conventions or, within the European Union Council regulation (EC) No. 44 / 2001 / regulation (EU) No 1215 / 2012. Where such recognition / enforcement is not governed by specific provisions, the recognition and enforcement of a foreign judgment is governed by the Code of Civil Procedure. Within this legislation, recognition is a prerequisite for the enforcement of a foreign judgment. In general, foreign judgments are automatically recognized by German courts unless one of the following exceptions applies:

- The foreign court did not have jurisdiction pursuant to German law on international jurisdiction;
- The respondent did not have the opportunity to defend itself due to wrongful or late service of the documents initiating the action;
- The judgment is inconsistent with a German judgment or an earlier recognizable foreign judgment, or the underlying foreign proceedings are incompatible with earlier German proceedings;
- The recognition of a foreign judgment would be contrary to German public policy; or
- Reciprocity has not been granted.

A recognized foreign judgment then needs to be declared enforceable by a judgment of a German court. The court will render such judgment only if the foreign judgment is recognized and final.

Under the above-mentioned European Union regulation and under certain conditions, it is not necessary to obtain a judgment of a German court declaring a foreign judgment enforceable; it is sufficient to obtain an execution clause from the court.

## 18.6 Arbitration

### 18.6.1 Arbitration Law

Arbitration is a popular means of dispute resolution in Germany, where there is a long tradition and a large number of experienced arbitrators and practitioners active in that field of law. In particular, disputes related to M&A transactions, large construction projects and international contractual disputes are frequently referred to arbitration in Germany. The proceedings are typically conducted in English. Arbitration proceedings having their place of arbitration in Germany are governed by the arbitration law contained within the German Code of Civil Procedure. The provisions are based on the UNCITRAL Model Law on International Commercial Arbitration. As a result, foreign parties opting for arbitration proceedings in Germany encounter a highly developed and efficient system based on international standards.

### 18.6.2 Ad Hoc Arbitration and Institutional Rules of Arbitration

Under German arbitration law, the parties are free to agree on their own rules of arbitration. Whereas ad hoc arbitration proceedings are admissible and used, the parties usually refer to institutional arbitration rules (e.g. to the Arbitration Rules of the German Institution of Arbitration – DIS Arbitration Rules).

The German Institution of Arbitration promotes arbitration and provides for a uniform service for all arbitration related matters across Germany. The DIS Arbitration Rules are suited to both domestic and international arbitration proceedings; they reflect international standards in arbitration and differ only in minor aspects from the rules of other major institutions.

Parties involved in cross-border transactions frequently opt for arbitration in Germany using the rules of other institutions such as the International Chamber of Commerce (ICC). This approach is fully accepted and enforceable under applicable German arbitration law.



### 18.6.3 Enforcement of Arbitral Awards

#### 18.6.4 Domestic Awards

A German arbitral award (where the place of arbitration is in Germany) can be enforced after it has been declared enforceable by the competent Higher Regional Court. Such order can be obtained quickly and easily from the Higher Regional Court.

The Higher Regional Court will refuse to declare the award enforceable only for limited and specific reasons. At the same time the defendant in the enforcement proceedings must challenge the award before the Higher Regional Court within three months, otherwise the award will become binding and must be declared enforceable.

#### 18.6.5 Enforcement of Foreign Arbitral Awards

Germany is a member of the New York Convention on the Recognition and Enforcement of Arbitral Awards. Therefore, a foreign arbitral award will be easily recognized and enforced in Germany, in accordance with the provisions of the New York Convention. This holds true regardless of whether or not the country in which the award was made is a party to this Convention. Hence, German arbitration law accepts that arbitral awards are meant to be final and binding.

The substance of the award will not be reviewed by the Higher Regional Court. A formal application to the Higher Regional Court is necessary to obtain a declaration of enforceability (which is quickly issued). The Higher Regional Court will refuse the recognition of the award only for a limited number of specific formal reasons.

#### 18.6.6 Setting Aside / Refusal of Recognition of an Award

According to the Code of Civil Procedure, the Higher Regional Court will refuse to declare an arbitral award enforceable only if: (i) the arbitration agreement is invalid; (ii) a party was not given proper notice of the appointment of an arbitrator or of the arbitration proceedings; (iii) the award deals with a dispute not contemplated by or not falling within the terms on which the dispute was submitted to arbitration or contains a decision on matters beyond the scope of

these terms; or (iv) the arbitral procedure or the composition of the arbitral tribunal contravened the Code of Civil Procedure or an admissible agreement between the parties and this contravention affected the award.

In addition, the court will refuse to declare an arbitral award enforceable if it finds that the subject matter of the dispute was not capable of resolution by arbitration under German law or recognition or enforcement of the award would lead to a result that would conflict with public policy.

Defenses based on substantive law are inadmissible and will not be heard. For domestic (German) arbitral awards, it is insufficient to object to the declaration of enforceability; the defendant must challenge the award itself within three months before the Higher Regional Court.

#### 18.6.7 The Role of the Courts

The role of the German courts in arbitration is limited. If a dispute is subject to an arbitration agreement, the court will dismiss a claim upon objection of the other party if it is nevertheless brought before it. Until an arbitral tribunal is constituted, any party may file a motion with the Higher Regional Court to establish by declaratory judgment whether or not the arbitration clause or arbitration agreement is valid. After commencement of arbitration proceedings, only the arbitral tribunal has jurisdiction over the question of whether the arbitration agreement is valid (*Kompetenzkompetenz*). The state courts will be involved only to assist the Arbitral Tribunal (e.g. to summon witnesses) or when it comes to the enforcement of an award.

### 18.7 Alternative Means of Dispute Resolution

Alternative means of dispute resolution represent an alternative to adversarial proceedings before a court or an arbitral tribunal. There are few specific statutory rules providing for rules for alternative dispute resolution procedures in Germany. Rules for mediation procedures have recently been adopted. Other forms of alternative means of dispute resolution are also available, e.g. conciliation (*Schlichtung*), adjudication and binding expert opinion. For the latter, the parties are, based upon the general legal principle of freedom of contract, free to agree on binding rules since no specific statutory rules exist. Although

interest in alternative dispute resolution methods, especially in mediation, has increased recently, many companies are still reluctant to agree on such methods.

### 18.7.1 Mediation

Mediation proceedings are codified in the act on the promotion of mediation and other alternative dispute resolution. The codification goes back to EU directive 2008 / 52 / EG.

In mediation, the parties are supported by a qualified and neutral mediator who acts as a facilitator of the parties' own negotiations rather than as an arbitrator. The parties are free and flexible in their negotiations – giving the parties the opportunity to develop uncommon and innovative solutions in a time-effective, cost-effective and confidential way. The information that is disclosed during these proceedings will not be admitted as evidence before any court of law or arbitral tribunal.

Mediation is beneficial for the parties to a dispute because it respects not only past events which led to the conflict, but also future relations between the parties. Thus, it allows the parties to adopt a common approach to their common conflict. Mediation can be considered when the complexity of the conflict makes it likely that the judgment of a court of law will be unsatisfying for both parties. However, the parties need to show an honest intention to consider each other's perspective: the flexibility of the proceedings leaves each party with the possibility to enter proceedings before a court of law or an arbitral tribunal. Mediation proceedings delay the limitation period of potential claims (*Verjährungsunterbrechung*).

Even though the mediation does not have a binding effect and a settlement agreement resulting from such mediation is not immediately enforceable, the successful finding of a mutual agreement effectively prevents subsequent conflicts, as is statistically proven.

### 18.7.2 Court Connected Conciliation

A comparatively new means of dispute resolution is the court connected conciliation hearing. In contrast to mediation, a specially trained state conciliation judge (*Güterichter*) conducts the conciliation hearing after a claim is filed with the court. The conciliation judge is expressly encouraged by law to use mediation techniques in the proceedings.

The conciliation is ordered at the discretion of the regular judge if he / she believes that there are sufficient chances for an amicable settlement. If conciliation fails, the regular court proceedings will continue. The conciliation judge will not be allowed to sit as a judge in the state court proceedings on the same issue.

An important factor for a successful mediation or conciliation is the qualification of the mediator / conciliator. The judges acting in this regard are specially trained, but sometimes lack sufficient experience in handling conciliation proceedings in complex cases. As a result, court connected conciliation often turn out to be inefficient and do not result in a compromise solution.



# Doing Business in Germany

# Typically German



**The Deutsche Nationalmannschaft** (German soccer team) is one of the most successful soccer teams worldwide. Overall, it is three times European Champion and four times World Cup winner. On 13 July 2014 the team of Jogi Löw won the World Cup final in Rio de Janeiro, Brazil, and gained its fourth star on the national jersey.

\* Texts taken from publicly available sources (Internet etc.)

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## 19 PUBLIC PROCUREMENT

### 19.1 Public Contracts

Public procurement law (primarily contained in Chapter 4 of the Act Against Restraints of Competition – GWB) regulates the purchase of services, goods and works by public authorities in the public and utilities sector. There are also public procurement provisions specifically designed for the more sensitive defense and security-related contracts.

German public procurement law is largely determined by European Directives. Therefore, the law is designed to open up the German public procurement market to competition, to prevent "buy national" policies, to promote the free movement of goods and services within Europe and to guarantee economic spending of taxpayer's money. With expenditures of German public authorities amounting up to about EUR 300 billion each year the purchase of public contracts is an important field of business. These public procurement regulations only apply for contracts conducted by public authorities, whose estimated value reach or exceed certain thresholds. For supply and service contracts conducted by Supreme and Superior Federal and comparable federal institutions, the threshold is EUR 134,000 for other supply and service contracts EUR 207,000 and for works contracts EUR 5,186,000.

### 19.2 Contracting Authorities

There are different types of contracting authorities that have to observe the provisions mentioned above. These include all classic public authorities, especially the Federal Government, the State Governments and municipalities as well as co-operations thereof. Additionally, private corporations which perform public purposes and predominantly belong to or are controlled by classic public authorities are deemed contracting authorities according to public procurement law. Contractors operating in the so-called utilities sectors (drinking water supply, energy supply, transport services) on the basis of special or exclusive rights granted by a public authority also have to follow the procedural rules of public procurement law. Other private entities involved in the implementation of special governmental-supported activities, for example, the construction and operation



of hospitals, sports, school or leisure facilities or universities have to observe public procurement law, as well.

### 19.3 Contract Notice

The principle of transparency requires contracting authorities to announce their intention to award a contract in advance, with a so-called contract notice (*Bekanntmachung*). The contract notice must be published for example in daily newspapers, official publications or trade journals. Contract notices regarding contracts equalling or exceeding the thresholds set by European law must be published in the Supplement to the Official Journal of the European Commission which is available online (<http://ted.europa.eu>).

### 19.4 Award Procedures

German public procurement law offers several different ways to award a contract. Contracting authorities may use the following procedures:

- The open procedure, in which all interested contractors may submit a bid;
- the restricted procedure (two-step-procedure), in which, first, an invitation to participate is published and the contracting authority selects a limited number of the interested bidders to submit a tender subsequently;
- the negotiated procedure, in which the contracting entity consults companies of its choice, with or without a contract notice, and negotiates the terms of the contract with one or more of them; and
- the competitive dialogue, in which a contract notice is published and the contracting authority conducts a dialogue with the candidates admitted to that procedure with the aim of developing one or more suitable alternatives capable of meeting its requirements and on the basis of which the candidates are invited to tender.

As a general rule the open procedure has priority. A deviation from this principle is only permissible if a statutory exception exists and the contracting authority gives a written justification. Circumstances in which the restricted or negotiated

procedure or the competitive dialogue is permissible are stated in the German contracting regulations. In the open or the restricted procedure, which are very formal procedures, offers are excluded if they contain changes or amendments to the tender documents. This does not apply for negotiated procedures which explicitly allow changes to tender documents, as well as alternative bids. Alternative bids and tenders in negotiated procedures, in general, only have to fulfil the so-called "mandatory" requirements.

## **19.5 Procurement Principles**

As German procurement law aims largely at implementing European Commission Directives on public procurement, it concentrates on principles resulting from European primary law. Thus, public contracts may only be awarded on the basis of a competitive award procedure, which must be transparent and non-discriminatory. Additionally, the promotion of small business' interests, contained in paragraph 3 of Section 97 GWB, must be respected. These main principles have to be observed during every step of the procurement process.

Furthermore, agreements between competing enterprises that would effect the prevention, restriction or distortion of competition are prohibited. Each bidder who is party to anti-competitive agreements regarding the tender is excluded from it.

## **19.6 Selection & Award Criteria**

### **19.6.1 Suitable Bidders**

Contracts are awarded to bidders that are suitable with regard to the subject of the contract. A bidder is suitable if he possesses technical knowledge, efficiency and reliability, which means in particular, that he has to provide the ability to carry out the contract according to applicable rules, within the time limits set by the contracting authorities and follow the instructions given by them. Additional selection criteria are only admissible if federal or state law provides for them. Among these so-called non-award-related criteria that Federal and state legislators have implemented are the promotion of women, the fight against clandestine employment, and the protection of the environment. A contracting authority may – and in certain cases even must – exclude a bidder from the tender pro-

cess, where certain grounds concerning the bidder's personal position (e.g. professional misconduct, involvement in organized crime, corruption, fraud or money laundering) or economic and financial capacity (e.g. bankruptcy) are met.

## 19.6.2 Most Economically Advantageous Tender

The contract has to be awarded to the most economic tender. This includes consideration of the price because the award criterion of the most economic tender is aiming at an optimum price-performance ratio. In addition, other factors such as quality, life cycle or running costs, or technical merit may be considered. All award criteria as well as their relative importance for the award decision need to be published with the contract notice.

## 19.7 Remedies

### 19.7.1 Preliminary Information

Contracting authorities must notify all parties (i.e. all those who submitted a bid) of their award decision in writing, allowing a so-called standstill period of at least 10 days prior to the award. Within this standstill period informed parties are entitled to lodge a petition for judicial review to challenge the tender process. Contracts awarded before expiration of this so-called standstill period or without the preliminary information (*Vorabinformation*) are void. A fortiori, when contracts are awarded without any kind of tender procedure, i.e. direct award to one entity, they are also void due to violation of the preliminary information obligation.

### 19.7.2 Judicial Review above the European Union Thresholds

Since 1998 judicial review of public procurement activities in Germany is guaranteed on a two-level basis: First instance review is granted by Judicial Review Chambers (*Vergabekammern*) which are part of the administrative authority. Judicial Review Chambers exist on a federal and on a state level. Immediate appeals (*Sofortige Beschwerde*) against decisions of the Judicial Review Chambers are dealt with by specialized Review Senates (*Vergabesenate*) at the Higher Regional Courts (*Oberlandesgerichte*).

### 19.7.3 First Instance

For the perception of the procurement law remedies it is a necessary precondition to formally complain a violation of public procurement law immediately – which means within a period of not more than 10 to 14 days – towards the public authority. Only if the public authority does not remedy the infringement of public procurement law itself, a judicial review procedure is permitted.

A petition for judicial review filed with a Judicial Review Chamber suspends the award procedure, i.e. award of the contract is banned as soon as the petition for judicial review has been served on the contracting authority. A contract awarded despite of the suspension is void.

Judicial Review Chambers may review the award procedure with regard to all aspects of public procurement law. Accordingly, Judicial Review Chambers may grant a wide range of remedies such as execution of lawful measures, declaration of the unlawfulness of the award (on application) or termination of the suspension and admission to award the contract in advance (on application). Judicial Review Chambers are obligated to rule within a period of five weeks and give reasons for its findings in writing, although in exceptional cases this period might be extended.

However, as soon as the contract in question is awarded to another bidder Judicial Review Chambers cannot set aside the award or employ any other remedy. Hence the obligatory standstill period as well as the provision that a petition for judicial review filed with a Judicial Review Chamber suspends the award procedure.

### 19.7.4 Second Instance

The decision of a Judicial Review Chamber can be challenged with an immediate appeal (*sofortige Beschwerde*) to the Review Senate of the Higher Regional Courts.

An immediate appeal must include a statement of the grounds for appeal and must be filed within two weeks after the Judicial Review Chamber has served its decision to the respective party. The Review Senate acting as court of appeal

can either replace the Judicial Review Chamber's decision by its own or annul the decision of the Judicial Review Chamber and recommit it under the condition to consider the reasons given by the Review Senate.

### 19.7.5 Judicial Review below the European Union Thresholds

As the aforementioned legal protection system only applies to procurement procedures for contracts exceeding the European threshold values, contracts below the applicable threshold cannot be reviewed before the Judicial Review Chambers and the Review Senate. However, these procedures and contract awards can still be reviewed by civil or administrative courts to verify the legality of the public authority's decision under contract law. This also includes the assertion of a claim for damages.

### 19.7.6 Damages

In case of an infringement of procurement rules, bidders can also claim damages. This may include not only reimbursement of the costs for preparation of the tender and participation in the procurement procedure but also consequential damages caused by the unlawful award.

## 19.8 Special Forms of Cooperation

### 19.8.1 Service Concessions

It is generally known and commonly accepted that the award of service concessions does not fall within the scope of public procurement law. However, following case law certain procedural rules (such as the principle of transparency, non-discrimination and equal treatment of bidders) which resemble public procurement rules apply to the award of service concessions. Similar to privatizations and sales of public assets these procedural rules derive from European Commission primary law.

However, in January and February 2014 the European Parliament and the Council adopted an all new directive creating specialized procurement law provisions on the award of concessions (Directive 2014 / 23 / EU). This directive has to be transformed into national (German) law until May 17, 2016. Public authorities will then be obliged to address the award of a concession by way of

publication of a concession notice (which is an equivalent to a contract notice) in the Official Journal of the European Union and will have to comply with a differentiated procurement regulation.

## **19.9 Public Private Partnerships**

With regard to Public Private Partnerships (PPP) the overall economic purpose of the transaction is decisive. While the individual steps leading to a PPP, such as the formation of a separate legal entity, do not have to be put out to tender, a PPP itself normally operates on an operating or a concession agreement. Operating agreements will usually be considered as services contracts. Consequently, the selection of the private partner usually requires a tender procedure according to German public procurement law or in case of a concession according to certain procedural rules.



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