Newsletter
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PREFACE

We are pleased to be able to send you another edition of our Corporate Law and Taxation, Mergers & Acquisitions Newsletter.

In this edition we would like to bring you up-to-date on further legal developments which may affect your business activities.

For example, the recent case-law on the liability of shareholders where a dormant company is reactivated has created considerable uncertainty, and this should be taken into account in client discussions.

Moreover, there have been recent changes in connection with limited partnership shares held in trust, the premature reappointment of executive officers, D&O liability, the delisting of companies and single tax entities. If the one or the other of these topics is of particular interest to you, please do not hesitate to contact us. Our contact details can be found on the last page of the Newsletter.

Liability of Shareholders Following Reactivation of Dormant Private Limited Companies – New Ruling of Federal Court of Justice Limits Liability

Introduction

The principles elaborated by the Federal Court of Justice in its case law on the reactivation of dormant private limited companies and the resultant increase in the liability of shareholders of such dormant companies have in recent years resulted in a series of decisions by lower courts that have not always sufficed to handle situations encountered in actual practice and have resulted in excessive liability on the part of shareholders who intentionally opted for a form of incorporation that limited their liability in order to shield their personal assets against claims of creditors of the company. These various rulings have in the meantime caused a virtual deluge of scholarly debate in the legal literature that defies oversight and in some cases reveals the existence of diametrically opposed positions. The upshot has been a noticeable increase in uncertainty among practitioners, especially as regards the extent of the potential liability incurred in the case of the reactivation of a dormant company.

This unfortunate development was encouraged by the previous case law of the Federal Court of Justice, which either completely neglected to address certain aspects involved in the application of the principles governing liability following the reactivation of dormant companies or provided misleading information. In its judgment of 6th March 2012, II ZR 56/10, which has been published in DStR 2012, p. 974 et seq. and elsewhere, the Federal Court of Justice has fortunately taken the opportunity not only to confirm the validity of its principles regarding the liability of shareholders in the case of the reactivation of dormant private limited companies in the past, but also specifically addressed the issues of the duration and extent of the liability of shareholders and set limits for both.

Confirmation of Previous Pronouncements

a) The recent case law of the Federal Court of Justice has first of all confirmed the previous definition of what is meant by reactivation of a dormant company. Reactivation of a dormant company is taken to mean the acquisition of a shelf company or a shell company as well the resumption of the business operations of a dormant private limited company with no change in the shareholders.

b) The Federal Court of Justice considers cases that fall into the above category to represent the equivalent of the legal incorporation of a new private limited company and as a result would apply those provisions of law accordingly that govern the creation of an artificial person that did not previously exist. In order to protect creditors, these provisions governing the establishment of companies require that the capital required by law and the articles of association be actually paid in as of the commencement of the existence of the company since that is ultimately what justifies the limitation of the liability of the shareholders to the existing corporate assets in the first place. Application of these provisions in the case of the reactivation of a dormant company means that the managing director of the reactivated entity must notify the court of registry of the reactivation and submit a statement of compliance pursuant to section 8(2) of the Private Limited Companies Act (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung* – GmbHG) concerning the contributions pursuant to section 7(2) and (3) of the Private Limited Companies Act in respect of the shares and the unhindered availability of these contributions. In the event of failure to comply with this duty to disclose the reactivation of the dormant company, the shareholders are personally liable for the debts of the company.

c) Finally, the Federal Court of Justice confirmed that failure to disclose the reactivation of a dormant company not only affects the liability of those shareholders who were directly involved in the reactivation of the company, either by virtue of the purchase of a shelf or shell company or by virtue of the resumption of business operations of a company; shareholders who acquire shares in a reactivated dormant entity, i.e., from a company that has resumed business operations, are also liable regardless of whether they had positive knowledge of such reactivation.

Limitation of Liability

a) Due to the previous case law of the Federal Court of Justice, it was commonly thought up to now that shareholders would not only be personally liable for the integrity of the share capital in the case of the reactivation of a dormant company, but that this liability would also be of indefinite duration since the amount of personal liability was to be determined as of the time of the disclosure of the reactivation of the dormant entity to the court of registry and be equal to the difference between the amount set by law or the company's articles of association and the actual value of the company's assets. However, in the event of failure to make such disclosure, the liability of shareholders would be indefinite and also include losses that result in a reduction in the assets of the company after resumption of business operations, i.e., after reactivation of a dormant company.

This broad construction of liability in connection with the reactivation of a dormant company in the event of a breach of the duty of disclosure is logical in the case of the literal application of the provisions of law governing incorporation, which originally pertained to initial incorporation of a private limited company, and the corresponding case law of the Federal Court of Justice for this means that the shareholders are completely liable for all liabilities when the company is initially created – and then as shareholders of the company prior to entry in the register of companies – and to be sure for any losses incurred up to registration as well as for excessive debt thereafter. In the event a company has already incurred liabilities by commencing business operations prior to its entry in the register of companies, the shareholders are personally liable for the difference between the share capital and the value of the company's assets as of the time of registration (*liability for deficit balance*). In the event of failure to register a private limited company, the shareholders are personally liable for debt not covered by the company's assets (*liability for uncovered losses*).

b) In its decision of 6th March 2012, the Federal Court of Justice clearly rejected this far-reaching liability model. In the case of the reactivation of a dormant company that is not entered in the register of companies, the Federal Court of Justice now limits the liability of shareholders to the deficit balance as of the time the reactivated dormant company first makes its public appearance. That point in time is determined either on the basis of the time of registration of any changes in the articles of association made in connection with the reactivation of the company or the commencement of business operations. The possibility of indefinite liability for uncovered losses, which is possible in the case of the initial establishment of a private limited company, will in the future be excluded in the case of the reactivation of dormant companies.

The Federal Court of Justice correctly justifies this limit to liability by referring to the fact that the liability model originally developed specifically for initial legal incorporation is not necessarily completely applicable in the case of the reactivation of dormant companies since there are serious differences between initial incorporation and reactivation of a dormant entity that call for and justify a difference in liability. For example, as regards the liability of a shareholder of a reactivated dormant company, it is

necessary to take into account the fact that the entity in question is already entered in the register of companies when it is reactivated, which is not the case when a company is registered for the first time, and already exists as a legal entity that is separate from its shareholders such that its liability is limited to its corporate assets pursuant to section 13(2) of the Private Limited Companies Act. The required entry of a reactivated dormant company in the register of companies cannot be equated with initial entry in the register of companies, which is what gives rise to the legal existence of the company and limits its liability in the first place.

c) The Federal Court of Justice considers any further shareholder liability to be unnecessary despite the fact that unlimited liability for an indefinite period could exert a disciplinary influence on shareholders, who might otherwise ignore the duty to disclose the reactivation of a dormant company with virtual impunity. According to the court, preferential treatment of a company's creditors as compared with the situation in the case of proper disclosure would in any case not be warranted.

Conclusion

In its decision of 6th March 2012, the Federal Court of Justice put a welcome stop to the burgeoning liability of shareholders of private limited companies due to its previous case law by adapting and limiting the scope of the liability model it created for cases involving reactivation of dormant companies in the interest of greater legal certainty. However, since the Federal Court of Justice consistently insists upon application of the provisions of law governing incorporation, including the principle of liability for deficit balances, in the case of the reactivation of dormant companies, some basic doubt remains as to the validity of this ruling in respect of its constitutionality on the one hand and other possibilities for the protection of a company's creditors on the other hand. One need, for example, mention only prohibition of dividends and the principles governing liability for the destruction of the existence of a company.

Dr. Werner Mielke,
Dr. Mario Riechmann

Recent Case Law on the Liability of Investors and Trustees Acting as Limited Partners of Collective Investment Vehicles Organized as Limited Partnerships

(e.g., Federal Court of Justice decision of 24th July 2012/ZIP 2012, 1706 et seq.)

The German courts, including the Federal Court of Justice, increasingly find themselves called upon to deal with shares in investment funds held through trustees; such schemes enable investors to acquire shares in a fund, usually legally organized as a limited or general partnership, through a trustee. The purpose and benefits of this trust model are to some extent the subject of dispute in the scholarly literature. The model is, however, very popular, not only among operators of investment funds but also among investors, since it offers considerable convenience; for example, it is often possible to dispense with notarization of the acquisition of shares in such companies and entry of the names of individual investors in the register of companies. This also gives investors access to an investment vehicle that ensures maximum discretion since no trace can be found in public registration records. On the other hand, although this type of investment vehicle does seem to offer interesting benefits, it also presents investors with serious problems, especially if the fund company should find itself in financial difficulty.

According to the established case law of the Federal Court of Justice, investors who acquire shares in partnerships through trustees and are therefore not shareholders in the formal sense are nevertheless to be treated as such. They are therefore exposed to the same risks as actual shareholders, i.e., as though they also owned their shares in the company directly. In addition, they may not offset claims against the trustee, which can result in a total loss of their investment, especially in the case of insolvency on the part of the fund company.

1. Recent Decision of the Federal Court of Justice

In a recent decision (Ruling of 24th July 2012 – II ZR 297/11), the Federal Court of Justice ruled that investors that acquire shares in a fund company through a trustee cannot offset claims for damages against the trustee-shareholder in order to avoid recourse by the company's creditors.

a) Headnote

In the case of partnerships in which investors can hold shares under a trust agreement that is designed so that trustors enjoy the same status as other – direct – shareholders within the company, they may not offset claims for damages arising from prospectus liability that they have against the trustee-shareholder against pecuniary claims arising from the right of the trustee-shareholder to be held harmless from claims of the company's creditors.

b) Facts

The Plaintiff is the general partner of a closed real estate fund organized as a general partnership. Acting in the capacity of trustee, the Plaintiff administers the investments of Defendants 1 and 2, who have agreed to hold the Plaintiff harmless from any claims for repayment of their proportionate shares of a loan brought by creditors of the fund company. The trust agreement does to be sure stipulate that the trustee is a shareholder in its own name, but that the contribution to capital inures to the trustors. The rights and obligations assumed by the trustee for the account of and in the interest of the trustors under corporate law, including any obligations to make further contributions to capital, were to pertain exclusively to the trustors. The statements made by the Defendants in the applications they signed upon joining the fund company stipulate that the managing partner authorized to represent the company will enter into agreements with third parties in the name of the company only if it is explicitly agreed that the liability of the other shareholders will be limited to an amount corresponding to their respective proportionate shares of the capital of the

company. The articles of association also stipulate that the liability of the shareholders – with the exception of the managing shareholder – vis-à-vis one another will be limited to an amount corresponding to their respective proportionate shares of the capital of the company. When financial difficulties arose, the Plaintiff asked to be released from any liability towards creditors of the fund company by the Defendants. The Defendants then responded to the request of the Plaintiff by presenting claims for damages due to various misstatements in the offering prospectus.

c) Decision

The Second Civil Senate confirmed the Plaintiff's right to be held harmless from the claims of the creditors of the fund company against the Defendants arising from the trust agreement in conjunction with sections 675 and 670 of the German Civil Code (*Bürgerliches Gesetzbuch* – BGB). The fact that the Plaintiff first assigned the right to be held harmless to a creditor of the company and this right was then assigned back to the Plaintiff does not in any way affect the Plaintiff's right of action. The court ruled that such reassignment does not impair any legitimate interests of the debtor and serves to safeguard the legitimate interests of the Plaintiff and the creditor of the company. The Federal Court of Justice considers the question irrelevant and therefore did not rule on whether the creditor's claims to payment would have been reconverted into rights to be held harmless after reassignment to the Plaintiff. In any case, according to the court, the Plaintiff's right to be held harmless was converted into a claim for payment through the serious and final refusal of the Defendants to make payment in the proceedings pursuant to sections 280(1) and (3), 281(1) and (2) and 250 of the German Civil Code .

Referring to its ruling on the right to be held harmless of a trustee acting as limited partner that had been assigned to an insolvency administrator, the Federal Court of

Justice completely rejected the possibility of allowing the Defendants to offset any claims for damages, stating that the question as to whether the claims for damages due to breaches of a duty of disclosure even existed in the first place need not be addressed. The court held that the relationship between the company and trustors is a fiduciary relationship with superimposed commitments governed by corporate law and that the Defendants agreed in their applications not only to make contributions to capital, but also to cover liabilities towards the company's creditors with their personal assets. The court stated that this ruling also applied to general partnerships and that the liability of a shareholder of a general partnership was comparable with reinstated liability in the case of a limited partner. The fundamental reason for not allowing offsetting is that trustors in companies may not be privileged nor discriminated against as compared with direct shareholders. According to the court, this would apply equally to both corporate forms.

The court also saw no need to make a distinction as compared with cases in which an insolvency administrator of a fund company brings the claims of the creditor since it would not seem proper for the liability of the trustors to become greater after insolvency proceedings are initiated than they were prior to such proceedings.

d) Practical Implications

The decision of the Federal Court of Justice describes the legal consequences of administrative trusts (referred to as "artificial trusts", in which case trustees do to be sure become shareholders in their own name, but hold the contribution to capital exclusively for the account of and in the interest of trustors) that adopt the legal form of a general partnership in a manner that is detrimental to trustors. The court's decision is consistent in that it accords trustors who hold shares the same financial status as direct shareholders. This will therefore facilitate the situation of trustees as regards their liability in the context of such administrative trusts since trustees previously had to deal with the question as to who was responsible for the liabilities of the respective fund company. This has now been conclusively clarified in favor of trustees, whose purely administrative function has been confirmed by the Federal Court of Justice.

2. Outlook

According to the established case law of the Federal Court of Justice, investors who hold interests in investment companies through trustees are not to be treated better or worse than investors who hold their shares directly (see Federal Court of Justice, Ruling of 22nd March 2011 – II ZR 215/09, BeckRS 2011, 09691, para. 29). They therefore bear the full risk associated with their investment. It can therefore be anticipated that trustees will also continue to require that trustors hold them harmless from that percentage of the company's liabilities corresponding to their interests in the event the fund company finds itself faced with financial problems. Investors are therefore advised to familiarize themselves thoroughly with the benefits and possible disadvantages of investments in investment companies through a trustee.

Dr. Yorick Ruland

Premature Reappointment of Executive Officers of German Public Limited Companies

Introduction

The executive officers of a German public limited company (*Aktiengesellschaft*) are appointed by the company's supervisory board, which may appoint such officers for a term of up to a maximum of five years (first sentence of section 84(1) of the Stock Corporation Act (*Aktiengesetz* – AktG)). Supervisory boards may, however, also reappoint officers or extend their term of office (second sentence of section 84(1) of the Stock Corporation Act) by adopting a resolution to that effect no earlier then one year prior to the end of a term of office (third sentence of section 84(1) of the Stock Corporation Act). Before the Federal Court of Justice (*Bundesgerichtshof*) ruled on the issue, it was not clear whether an officer could resign from his position voluntarily in agreement with the supervisory board earlier than one year prior to the end of a term and be reappointed for a subsequent term of five years. Some were of the opinion that the above procedure would constitute illegal circumvention of the provision of law contained in the third sentence of section 84(1) of the Stock Corporation Act and that such appointments would therefore have to be considered to be of no validity or effect.

Decision of the Federal Court of Justice

The Federal Court of Justice had an opportunity to address this issue in its recent judgment of 17th July 2012 (NZG 2012, 1027).

According to that judgment, executive officers may, as a rule, be reappointed for a (maximum) term of five years if they resign more than one year prior to the end of an original term of office, and this also applies if there is no particular reason for such reappointment.

In the case before the Federal Court of Justice, a supervisory board decided unanimously to accept the voluntary resignation of an executive officer more than two years prior to the end of that officer's term of office and immediately reappointed the latter for a further term of five years. The officer in question then submitted his resignation the same day.

According to the Federal Court of Justice, the fact that the officer resigned only afterwards was no reason for misgiving since the latter indicated retrospectively his agreement with the termination of the initial term of officership and did this within a short time. It is, however, necessary to take into account in this context that unilateral termination of the appointment of the executive officer by the supervisory board would otherwise have been possible only for good cause (first sentence of section 84(3) of the Stock Corporation Act).

The Federal Court of Justice also saw no improper circumvention of the provision against premature reappointment of an executive officer within the meaning of the provision contained in the third sentence of section 84(1) of the Stock Corporation Act. Paragraph 5.1.2 of the German Corporate Governance Codex (DCGK), according to which this option may be exercised only under special circumstances, is also occasionally cited in this context. According to the Federal Court of Justice, the purpose of the above provision is not, however, defeated if the resignation of the officer is mutually agreed, the reason being that the purpose of the third sentence of section 84(1) of the Stock Corporation Act is to ensure that a supervisory board decides anew at least every five years whether to reappoint officers or extend their term of office.

The court ruled that this condition is fulfilled in the case of resignation upon mutual agreement followed by reappointment and that the five-year limit pursuant to the third sentence of section 84(1) of the Stock Corporation Act is respected such that the company is adequately protected against unreasonable financial burdens. In fact,

the Court reasoned that the period of commitment by the company is even shorter in the case of premature termination than the maximum period prescribed by law.

Finally, the Federal Court of Justice found that the supervisory board's decision was not made with abusive intent in this case, mentioning by way of argument in particular that the members of the supervisory board had made their decision unanimously despite the fact that half the members represented one branch of an alienated family and half the other branch. The elected procedure was therefore not intended to create a fait accompli prior to an impending annual shareholders' meeting at which a new supervisory board would be elected.

Practical Implications

The decision of the Federal Court of Justice clearly shows that the reappointment of officers following resignation by common agreement earlier than one year prior to the end of an original term of office is also permissible in the absence of any objective reason for such reappointment. However, the end of the term of office must be mutually agreed by the respective officer and the supervisory board since a supervisory board can otherwise terminate an officership only for good reason. In such cases, it is therefore recommended that the respective officer attend the corresponding meeting of the supervisory board and that a record be kept of the agreement to terminate the appointment by mutual consent. In the case of publicly traded companies, it is also necessary to take into account that the current German Corporate Governance Code stipulates that this possibility normally exists only under special circumstances. In the event that this should not be the case, this must be mentioned in the statement of compliance with the German Corporate Governance Code required pursuant to the first sentence of section 161(1) of the Stock Corporation Act along with the reason for failure to comply with paragraph 5.1.2 of the German Corporate Governance Code.

Clemens Scholz-Remes,
Dr. Martin Nentwig

The decision of the Federal Court of Justice clearly shows that the reappointment of officers following resignation by common agreement earlier than one year prior to the end of an original term of office is also permissible in the absence of any objective reason for such reappointment.

Problems Encountered in Connection with the Assessment of D&O Liability

Introduction

The subject of claims against executive officers of public limited companies and managing directors of private limited companies has become increasingly topical in recent years. The problems involved pertain to claims against former executive officers of financial institutions (e.g., in the case of Bayerische Landesbank) as well as against executive personnel in other sectors.

General Allocation of Burden of Proof

In the case of D&O liability claims, a company (or an insolvency administrator) initiating an action benefits from the general burden of proof rule contained in the second sentence of section 93(2) of the Stock Corporation Act (*Aktiengesetz* – AktG), which also applies by analogy to private limited companies. As a result, the company must at first only provide evidence and proof of the existence of a possible breach of a fiduciary duty. The respective executive officer must then furnish exculpatory evidence, for example, by relying upon the business judgment rule (second sentence of section 93(1) of the Stock Corporation Act). In such cases, it will frequently be impossible to provide exculpatory evidence, in particular if a decision that subsequently proves to have been ill-advised is found to have been based upon inadequate information.

Assessment of Loss in the Case of Complex Business Decisions

On the other hand, a company initiating such an action must provide evidence and proof of the existence of a loss and the corresponding monetary amount, but it is often difficult to furnish such proof of a loss in the case of complex business decisions. Examples would include infelicitous corporate sales and acquisitions or legal transactions. The obligation to provide proof in the case of an infelicitous legal transaction can be problematic if, for example, it is not the transaction itself that is ill-advised, but rather the conditions that are unfavorable (e.g., leases or financing agreements). If a company is dependent upon the execution of such agreements, executive officers who find themselves held liable will often argue that there was “no alternative” to agreements containing those conditions because no other possibilities were available.

Inadequate Documentation

The situation takes on a paradoxical twist in such cases since an executive officer who has not even gone to the trouble to investigate alternate possibilities more closely and made a decision regarding the matter at issue on the basis of no information at all will be the one with especially good possibilities for mounting a defense since any possibilities that may have existed will in such cases not have been examined and the company bringing the action would have to do so in retrospect and then also provide evidence and proof of the viability of such alternate courses of action in the proceedings. In such cases, deviation from the technical rules of evidence may be available pursuant to section 287 of the German Code of Civil Procedure (*Zivilprozessordnung* – ZPO) (assessment of loss by the court), which applies in the case of causality issues.

It can also be well imagined that the principle of good faith dictates that an executive officer or managing director may not rely upon any actual uncertainty resulting from misconduct on his part. It will be necessary to await the impact of these notions on the case law since no rulings on this issue have been forthcoming from the Federal Court of Justice or higher regional courts.

Assessment of the Implications of Poor Decisions

The question as to whether the implications of business-related decisions should be taken into account in the assessment of losses represents a further problem.

In such cases, the courts often point out that losses must be assessed from an overall perspective. Accordingly, not only the immediate implications of an ill-advised transaction are important in terms of assessing the amount of the loss; it is also necessary to examine the consequential results as compared with the projected hypothetical performance of the company's entire business operations based on the assumption of proper management.

This – substantively right – view of the issue involved can make litigation difficult since it to some extent negates the effect of the rule governing the allocation of burden pursuant to the second sentence of section 93(2) of the Stock Corporation Act, the reason being that it will inevitably prove very difficult to make hypothetical assumptions as regards a company's performance with absolute certainty if claims are brought years later (claims now become time-barred ten years after the tortious event in the case of publicly traded companies). Here too, judicial assessment of the loss pursuant to section 287 of the Code of Civil Procedure will regularly represent the only means of estimating the amount of the corresponding loss once a breach of duty is ascertained.

Special Treatment in the Case of Insolvency

D&O liability claims are often brought by insolvency administrators. A problem that frequently arises in the case of unsound transactions is that losses take the form of liabilities towards third parties. Such liabilities represent insolvency claims that will regularly be settled only on the basis of the payout dividend from the insolvent estate.

Nevertheless, a company will still be entitled to collect payment of the full stated amount of the liability even if undergoing insolvency. For the purposes of recourse against debtors, the case law recognizes receivables as debts that are recoverable in the full nominal amount even if insolvency proceedings have been initiated against the creditor and only that portion of the corresponding liability will actually be satisfied that is based on the payout dividend. In the case of the insolvency of the creditor, its right of recourse is converted into a claim in the full amount of the claim of the third party. The fact that the creditor will receive only that share of the claims determined on the basis of the payout dividend is irrelevant.

Summary

In summary, it is to be noted that the assessment of losses in the case of D&O liability claims can result in significant problems at the level of legal disputes that should be addressed in advance. In many cases, a company bringing an action will have to react to the legal stance of the court in an ongoing action and retrospectively substantiate its loss. In addition, deviations from the technical rules of evidence pursuant to section 287 of the Code of Civil Procedure often also apply. Such deviations from the technical rules of evidence are especially likely in the case of uncertainty due to breach of fiduciary duty on the part of the officer against whom action is taken.

Dr. Klaus Felke

Delisting and Downgrading in Light of the German Federal Constitutional Court's Decision dated 11th July 2012 – Recommendations for Action in Practice

There have been some remarkable court decisions on regular delisting (complete withdrawal from the stock exchange) and downgrading (change from trading on the organized market to a qualified segment of the open market (*Freiverkehr*) on a German stock exchange) in the recent past. In its "delisting" judgment dated 11th July 2012, the German Federal Constitutional Court (*Bundesverfassungsgericht*) rejected for constitutional grounds the reasoning of the Federal Court of Justice (*Bundesgerichtshof*) in what had been up to that time the Federal Court of Justice's seminal case law on delisting. In contrast to the view taken by the Federal Court of Justice, the Federal Constitutional Court regards the transferability of a share as merely an opportunity for earnings and trade, which is not within the ambit of Article 14 of the German Constitutional Law (*Grundgesetz*). The implications of the Federal Constitutional Court's decision on delisting and downgrading are discussed below.

Introduction

The German Federal Court of Justice's "Macrotron" Case Law

The German Federal Court of Justice held in its 2002 "Macrotron" judgment (BGHZ 153, 47) that the prerequisites for a regular delisting were (i) a resolution adopted at the annual general meeting, (ii) a mandatory offer of compensation to the minority shareholders, and (iii) the possible review of the offer of compensation in valuation proceedings. The court ascertained these prerequisites through drawing an overall analogy with sections 305, 320b and 327b of the German Stock Corporation Act (*Aktiengesetz*) and sections 29 and 207 of the German Reorganization Act (*Umwandlungsgesetz*) and based its reasoning primarily on a finding that delisting affected the transferability of a share and thus the fundamental right to the guarantee of ownership (*Eigentumsgarantie*) of the shareholders (Article 14 of the German Constitutional Law). In addition, in its obiter dictum the German Federal Court of Justice held in the "Macrotron" judgment that the economic disadvantages suffered by the minority shareholders as a result of the delisting on the organized market could not be compensated for by the inclusion of the shares in the open market on a German stock exchange. Consequently, the delisting rules that had been developed should generally be taken into account in the case of a downgrading.

Diverging Decisions on Downgrading by the Lower Courts

The Munich Higher Regional Court (*Oberlandesgericht München*) and the Berlin Higher Regional Court (*Kammergericht*) deliberately diverged from the generalized approach which had been adopted by the German Federal Court of Justice. By drawing distinctions they decided in the specific cases at hand that a downgrading from the organized market to the "m:access" segment of the Munich Stock Exchange or to the "entry standard" segment of the Frankfurt Stock Exchange, which have rules aimed at guaranteeing quality and transparency, did not require an offer of compensation to the minority shareholders or a prior resolution passed by the annual general meeting (Munich Higher Regional Court, NZG 2008, 755; Berlin Higher Regional Court, NZG 2009, 752). The Munich Higher Regional Court and the Berlin Higher Regional Court based their decisions largely on the continued liquidity of a share in the quality segments of the respective open markets. The factors that contribute to the liquidity of a share are the number of tradable securities, the number of free-float shares, the degree to which the company is known, the sector of industry to which the company belongs, its corporate announcements and its business development. The Munich Higher Regional

Court and the Berlin Higher Regional Court also justified their decisions by reference to the actual changes that had occurred in relation to over-the-counter trading, namely the increased quality and transparency requirements applicable to the partial segments “m:access” and “Entry Standard”, which were established as quality segments of the open market after the “Macrotron” decision.

As far as can be seen, until now only two courts have dealt with the issue of a change from the organized market to general open market trading on a German stock exchange. Both the Cologne Regional Court (*Landgericht Köln*) (AG 2009, 835) and the Frankfurt a.M. Higher Regional Court (*Oberlandesgericht Frankfurt a.M.*) (AG 2012, 330) have declared the principles in the German Federal Court of Justice’s “Macrotron” decision applicable in cases involving a lack of increased transparency and consequential duties and required in each case a resolution adopted at the annual general meeting as well as a compensation offer for the relevant change from one segment to another.

The Federal Constitutional Court’s Delisting Judgment dated 11th July 2012

In its judgment dated 11th July 2012, the First Senate of the German Federal Constitutional Court handed down its decisions on two constitutional complaints which both related to the German Federal Court of Justice’s development of the law on delisting in its decision in the “Macrotron” case.

In the case of one of the constitutional complaints, the majority shareholder had objected to being required to make an offer of compensation to the minority shareholders and to the review of the offer in valuation proceedings on the grounds that there was no statutory foundation for such requirements and that therefore the development of the law by the courts was to this extent illegal (1 BvR 3142/07).

In the second constitutional complaint, a minority shareholder asserted that it was absolutely necessary in the case of downgrading in the form of a change from the organized market to a quality segment of over-the-counter trading for this to be preceded by (i) a corresponding resolution passed at the annual general meeting, (ii) a compensation offer, and (iii) for such compensation offer to be reviewable in valuation proceedings (1 BvR 1569/08).

The German Federal Constitutional Court rejected both constitutional complaints and clearly stated in the course of its judgment that neither ordinary delisting nor downgrading affects shareholders' property rights (Article 14 of the German Constitutional Law). In the German Federal Constitutional Court's view, the increased transferability of the shares had to be viewed as merely an opportunity for earnings and trade, which was not relevant for the allocation of share ownership within the meaning of Article 14 of the German Constitutional Law. It therefore found that the "Macrotron" case law's requiring a compulsory offer and its review in valuation proceedings was unnecessary under constitutional law. However, at the same time, the German Federal Constitutional Court emphasized that the development of the law on delisting by the German Federal Court of Justice – for which there had been no constitutional necessity – was not impermissible and therefore did not constitute a violation of the principle that binds the judiciary to the law (Article 20(3) of the German Constitutional Law).

Practical Implications and Recommendations for Action

Delisting
As a result of the Federal Constitutional Court's judgment, the reasoning expounded in what had been the leading case up to such time, the German Federal Court of Justice's "Macrotron" decision on delisting, ceased to have effect. Since the German Federal Constitutional Court did not place the increased transferability of a share under the protection of the constitutional guarantee of ownership, it is unclear whether the German Federal Court of Justice will continue to uphold its "Macrotron" case law and, if so, how it will justify this in the future. If one takes the grounds on which the German Federal Constitutional Court's decision is based seriously (a delisting does not affect minority shareholders' legal rights and titles in a legally relevant way), then there are strong reasons for reconsidering the "Macrotron" principles and for abandoning them in part or in whole.

However, just a few months prior to the German Federal Constitutional Court's judgment, the German Federal Court of Justice expressly confirmed the necessity for an offer of compensation in the case of a delisting (German Federal Court of Justice, ZIP 2011, 1708 – *"Kässbohrer"*). As far as upholding the "Macrotron" principles is concerned, it would also be possible for the German Federal Court of Justice to rely on a value-based decision by the legislature which, in connection with the enactment of the revised version of section 29(1) of the German Reorganization Act, expressly referred to the development of the law by the German Federal Court of Justice.

As long as the German Federal Court of Justice does not expressly renounce the prerequisites for a delisting which it established through its judicial development of the law, it would be advisable for reasons of legal certainty not to delist a company without (i) a resolution adopted by the annual general meeting and (ii) an offer of compensation.

Downgrading
No offer of compensation has to be made to the minority shareholders where a company changes from trading on the organized market to a qualified segment of the open market on a German stock exchange and as to that

consequently no reviewability in valuation proceedings is required. However, it still remains unclear after the German Federal Constitutional Court's decision whether the consent of the annual general meeting is mandatory for a downgrading. Until this legal issue is decided by the German Federal Court of Justice, the question whether it is necessary for the annual general meeting to pass a respective resolution will remain open. According to our interpretation of the law, it would be reasonable not to require a resolution to be passed by the annual general meeting for a downgrading from the organized market to a quality segment of the open market; this would be in line with the decisions and arguments of the Munich Higher Regional Court and the Berlin Higher Regional Court.

If, however, the existence of the necessary majority at the annual general meeting is certain, we would recommend that it be asked for its consent to a downgrading prior to the execution of the downgrading since there is still – in our opinion – a small degree of legal uncertainty.

Dr. Christian Becker,
Lutz Pospiech

Planned Reform of Single Tax Entities

1. Introduction

The formation of a single tax entity for income tax purposes makes it possible to offset losses incurred by one company against profits realized by another company belonging to the same group. However, section 14 of the German Corporate Income Tax Act (*Körperschafts-steuergesetz* – KStG) requires that the controlling entity (parent) hold a majority interest in the controlled entity (subsidiary) and that a profit-transfer agreement be in place between the two companies.

In such cases, the subsidiary undertaking must also be registered in Germany and its management based in Germany. Management of the parent entity must also be based in Germany. This tax concept is currently undergoing scrutiny for two reasons. First of all, the requirement under German law that the subsidiary be both registered in and managed from Germany is problematic in view of the non-discrimination provisions anchored in European Union law and treaties. A case concerning such an infringement is currently pending before the ECJ (No. 2008/4909). Secondly, the execution and implementation of profit-transfer agreements are susceptible to errors in practice, which can unfortunately result in the creation of a "defective tax entity" with negative implications in terms of taxation such as, for example, intended covert distributions of dividends. Another problem lies in the fact that figures taken for the purposes of the transfer of profit are determined under accounting rules, which means they differ from those used for tax purposes. Given this situation, pending legislative proceedings contemplate changes in the current use of single tax entities.

2. Proposed Alternative Solutions

Prior to the current draft of the law, essentially two different basic approaches were discussed, a group contribution regime, which is derived from a proposal by the Hessian Ministry of Finance, and attribution models based on proposals by the Bavarian Ministry of Finance and the Institut für Finanzen und Steuern. All of these proposals would require that the controlling company and the controlled affiliate jointly apply to the tax authorities for permission to be treated as a single entity for tax purposes.

The group contribution model would permit intragroup contributions based on the actual transfer of profits. Joint application to the tax authorities by the companies involved would suffice to permit taxation as a group. Payments or claims of group companies would be treated as operating expenses by the payer company. Since transfers of profits should also be possible between individual group companies (and not only between parent and subsidiary) and the amounts unlimited, this model offered a high degree of flexibility. However, a very high shareholder interest, i.e., 95 % of capital and voting rights, was required in some cases.

In the case of the attribution models, taxation as a group would be possible if the controlling company and the affiliated public or private limited company file a joint application and the controlling entity holds a minimum interest of 75 % in the affiliate. Attribution of income would take place without any actual flow of funds, for example, by using what are referred to as tax settlement accounts under the Bavarian proposal.

3. Resolution of the Bundestag of 25th October 2012

On 25th October 2012, the Bundestag passed a bill that modifies the regime for single entity taxation (Bundestag document (*BT-Drucks.*) 17/11180), but it makes no provision for any fundamental change in the sense of an alternative model, calling instead for improvement in the previous single entity model. The approval of the Bundesrat has, however, not yet been forthcoming. This law contains the following changes: the requirement that both the place of registration and the place of management be located in Germany has been abandoned so that all companies registered in the EU or the EEA will qualify as affiliates for the purpose of group taxation. This is to apply to all cases in which final assessment has not yet taken place (section 34(8) of the Corporate Income Tax Act).

As regards controlling entities, the location of management will no longer be a decisive factor under the new legislation. In addition, it will in fact also be possible to include interests in domestic locations of parent entities. The necessary financial integration can therefore also be achieved through an interest in an affiliate held by a location of the parent entity throughout the entire duration of the single entity. In order to take into account the risk of non-taxation, the draft of the law calls for recognition of an undertaking only if the income that can be attributed to it is taxable in Germany under domestic tax law and international conventions. According to section 34(1) of the Corporate Income Tax Act, this change will be applied as of the 2012 assessment period.

In addition, the new legislation will facilitate the execution and implementation of profit-transfer agreements. Existing profit-transfer agreements that contain no reference to the obligatory assumption of losses as required by section 302 of the German Stock Corporation Act, which corresponds to the previous legal requirements, will not stand in the way of the recognition of single entities for tax purposes as long as the losses are actually assumed pursuant to section 302 of the German Stock Corporation Act and the nature of the assumption of losses revised to reflect the change in the law by 31st December 2014. As a result, old agreements must in any case be revised by no later than 31st December 2014. However, such revision of profit-transfer agreements will not be necessary pursuant to section 34(10b) of the Corporate Income Tax Act if the single tax entity ceases to exist before 1 st January 2015.

Implementation of agreements will also be facilitated since this is an important prerequisite for the existence of a single tax entity and the current legal situation entails various risks in this regard. In cases in which the transfer of profit is based on annual financial statements prepared for accounting purposes that contain accounting treatment errors, profit-transfer agreements will nevertheless be considered to have been implemented in compliance with the modified law under the following conditions: if (1) the final annual financial statements have been duly prepared; (2) any accounting treatment errors are such as to not have been amenable to discovery by applying the care of an ordinary businessman (this is the case if an unqualified audit opinion has been issued pursuant to section 322(3) of the German Commercial Code in respect of the annual financial statements or in respect of the consolidated financial statements that include the annual financial statements prepared for accounting purposes or in respect of a voluntary audit of the annual financial statements or certification from a tax accountant or auditor on the preparation of the annual financial statements with comprehensive opinions has been issued); and (3) any accounting treatment errors are corrected and any difference remitted or accounted for in the annual financial statements of the affiliate and the parent following detection of the error.

These conditions are to apply to all cases in which assessment is not yet final and absolute (section 34(7) of the Corporate Income Tax Act).

A further change concerns the restriction of the use of losses as a result of the abandonment of the double requirement governing domestic registration and management. This requirement is expanded to exclude negative income of a fully taxable parent entity or a fully taxable affiliate not registered in Germany if such income is taken into account for the purposes of taxation of the parent or the subsidiary or some other person in a foreign country that is not a member state of the EU/EEA (no. 5 under the first sentence of section 14(1) of the Corporate Income Tax Act). Here too, this will apply in all cases in which assessment is not yet final and absolute.

Finally, the law makes provision for a procedure for uniform assessment of the income of subsidiaries to be attributed to parent entities and as a result the respective tax bases of parent entities and their affiliates. Taxes paid by the subsidiaries that are to be credited toward the tax liability of parent entities are to be treated accordingly. Since the notice of assessment would have the function of a preliminary notice within the meaning of no. 10 under section 171 of the Fiscal Code (*Abgabenordnung* – AO), a subsequent change in the final assessment of the parent entity would be possible pursuant to no. 1 under section 175 of the Fiscal Code. This provision is intended to apply to assessment periods after 31 st December 2013.

4. Outlook

Although the Finance Committee of the Bundestag supports the complete abandonment of single tax entities in favor of a group taxation model, the coalition opted for smaller changes in the existing system. However, legal recognition of EU/EEA companies as affiliates represents an important step forward. The conveniences with respect to profit-transfer agreements are also welcome since they provide greater legal certainty as regards the existence of single tax entities. The Bundesrat failed to approve the law in late November. It remains to be seen whether the federal government or the Bundestag will initiates conciliation proceedings and what the outcome of such proceedings will be.

Dr. Thomas Winkemann

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