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PREFACE

Company law is subject to continual change. Recently, the liability of corporate organs, i.e. the liability of supervisory board members, executive officers and directors has become an issue of greater significance. This Newsletter covers this topic as well as a new financing form known as equity-line financing and, in addition, examines important court rulings on the economic realignment of companies.

RIGHTS AND DUTIES OF THE SUPERVISORY BOARD IN 2011

Whereas the rights and duties of supervisory boards previously only attracted occasional interest, since the high profile corporate collapses and crises of the 1990s lawmakers have begun to take more interest in their role. The enactment of the Act on Control and Transparency in Business (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich – KonTraG) in 1998 heralded the beginning of a tightening of duties and the extension of the area of responsibility of the supervisory board and its members. The idea was that the board should no longer consist of honorary members, but instead be made up of discerning advisers, who would be entrusted with responsible managerial tasks and advise management.

This trend has been continued through the legislative amendments of the last two years, namely through the Act to Modernize the Law Governing Private Limited Companies and to Combat Abuses (Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen – MoMiG) of 23 October 2008, the Accounting Law Modernization Act (Bilanzrechtsmodernisierungsgesetz – BilMoG) of 25 May 2009 and, most recently, through the Act on the Appropriateness of Management Board Remuneration (Gesetz zur Angemessenheit der Vorstandsvergütung – VorstAG) of 31 July 2009. We now propose to briefly present those changes which are especially significant for supervisory board members in practice in 2011.

1. AMENDMENTS INTRODUCED BY THE ACT TO MODERNIZE THE LAW GOVERNING PRIVATE LIMITED COMPANIES AND TO COMBAT ABUSES

The Act to Modernize the Law Governing Private Limited Companies and to Combat Abuses, which is mostly associated with amendments to the law governing private limited companies, also led to amendments of stock corporation law and in particular to an important extension of the supervisory board's catalogue of duties. As is the case with the shareholders in general meeting of a private limited company, where a stock corporation has lost its management, every member of its supervisory board is entitled pursuant to section 15(1) sentence 2 of the Insolvency Code (Insolvenzordnung – InsO) and, in the case of section 15a(3) of the Insolvency Code, obliged to petition for insolvency on behalf of the company if grounds for the initiation of insolvency proceedings exist.

The newly introduced section 15a of the Insolvency Code stipulates petitioning duties for all legal entities irrespective of their legal form; these were previously contained in individual legislation. The purpose of this amendment was to create a uniform duty to petition for insolvency for all legal entities, irrespective of their legal form, which also extends to foreign companies (Records of the Bundesrat (BR-Drs.) 354/07 (B), pp. 26 – 27). In the past, supervisory board members were limited to encouraging a petition from the executive decision-making body (management or managing directors), for example, by convening a general meeting pursuant to section 111(3) sentence 1 of the Stock Corporation Act (Aktiengesetz – AktG). Of course an individual supervisory board member only has a duty to petition for insolvency if he knows the stock corporation has lost its management and if there are grounds for instituting insolvency proceedings (company's inability to pay debts as they fall due or overindebtedness, cf. sections 16 – 19 of the Insolvency Code). Loss of management is defined in section 10(2) sentence 2 of the Insolvency Code as the lack of a representative organ; in this context, it is not enough if the representative simply cannot be reached (AG Hamburg NJW 2009, 304; Römermann NZI 2008, 641; Uhlenbrock/Hirte, § 15 marginal note 2A; for a view criticizing this and pointing out the dangers of abuse see Wälzholz, DStR 2007, 1914, 1916).

Furthermore, a supervisory board member will not have breached his duty to petition for insolvency if he can exonerate himself by proving that he did not have positive knowledge of either the grounds for petitioning for insolvency or the loss of management. According to the reasons provided by the government, simply the fact that he „should have known" is not enough to trigger such a duty (cf. Records of the Bundestag (BT-Drucks) 16/6140, pp. 55 – 56.). Conversely, a person who deliberately ignores knowledge of such circumstances remains obliged to lodge a petition (Records of the Bundestag op cit., p. 56). Moreover, a supervisory board member who knows that the company has lost its management will have a duty to check whether there are possibly grounds for petitioning for insolvency, and vice versa if he knows of grounds for petitioning for insolvency, he will have a duty to check whether the company has lost its management (Records of the Bundestag op cit, p. 55; Nerlich/Römermann/Mönning, § 15a marginal note 18.). Nevertheless, the knowledge of one supervisory board member of the actual requirements for initiation of insolvency proceedings will not be attributed to the other supervisory board members. Where a statutory

duty to petition for insolvency exists under the circumstances described, a supervisory board member who waits too long risks incurring a liability to the company's shareholders. This is because section 15a of the Insolvency Code is a protective act within the meaning of section 823(2) of the German Commercial Code (Bürgerliches Gesetzbuch – BGB). The (stricter) penal consequences of failing to lodge a petition are set out in sections 15a(4) and 15(5) of the Insolvency Code, which provides for the commission of an offence through negligence.

2. AMENDMENTS INTRODUCED BY THE GERMAN ACCOUNTING LAW REFORM ACT

In the course of a decision handed down at the beginning of the 1980s, the Second Civil Senate of the Federal Court of Justice (Bundesgerichtshof) interpreted section 111(5) of the Stock Corporation Act and the principle contained therein that supervisory board members must execute their functions personally in such a way as to mean that the members must possess a certain minimum amount of knowledge and ability, or at least be able to acquire such knowledge and ability, in order to be able to deal with the company's ordinary business without having to enlist the help of external experts (Federal Court of Justice, judgment of 15 November 1982 – II ZR 27/82, BGHZ 85, 293, 298 = NJW 1983, 991; cf. MüKo AktG/Kopff, § 107 marginal note 94). Section 100(5) of the Stock Corporation Act, which was amended by the Accounting Law Reform Act, adopts this principle. According to that section, a listed company within the meaning of section 264 of the German Commercial Code (Handelsgesetzbuch – HGB) must fill its supervisory board with at least one member who is independent and who has expertise in the fields of accounting or auditing. How the supervisory board member acquired his expertise in one of the two areas is unimportant (cf. Munich Higher Regional Court, Preliminary Opinion of 28 April 2010 – 23 U 5517/09, NZG 2010, 784). In this context, a company now has the option pursuant to section 107(3) sentence 2 and 107(4) of the Stock Corporation Act of establishing an audit committee to monitor accounting processes and establishing other mechanisms for checking audits. Such committee must have at least one member who has the special qualifications called for by section 100(5) of the Stock Corporation Act.

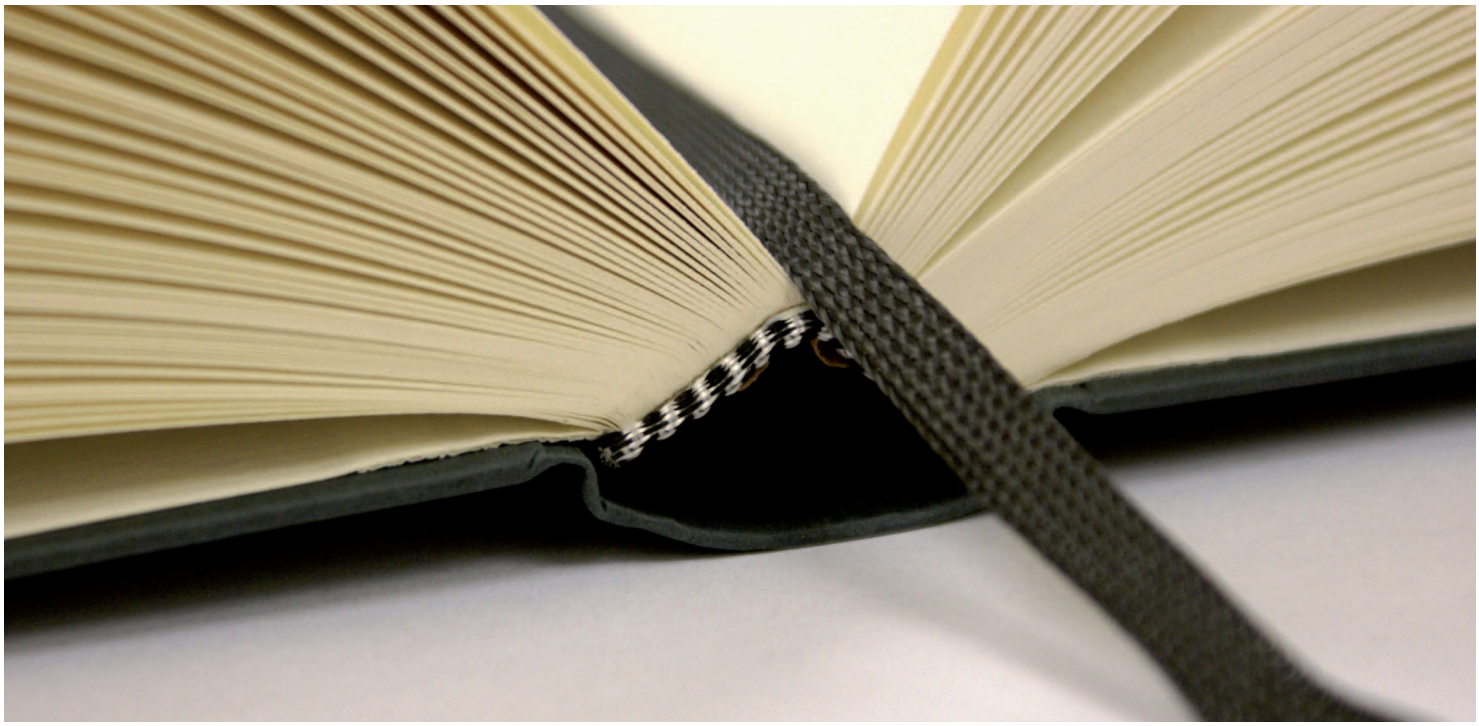
Naturally, the provision only applies to supervisory board members who were appointed after the Accounting Law Reform Act entered into force (Hüffer, AktG § 100 marginal note 12. Art. 6(4) EGAktG). Nevertheless, future candidates should bear in mind that by assuming the post of expert supervisory board member they may also be increasing their own liability. The reason for this is that certain standardized duties of care may be owed when performing their functions, especially in relation to sections 116 and 93 of the Stock Corporation Act; above-average knowledge and experience would at the same time find its corollary in above-average liability (Kropff in FS K. Schmidt (2009), pp. 2022, 2039).

3. AMENDMENTS INTRODUCED BY THE ACT ON THE APPROPRIATENESS OF MANAGEMENT BOARD REMUNERATION

In the wake of the financial crisis, public discussion has begun to focus on managers' salaries. Essentially, the central issue is always the appropriateness of salaries and the structure of performance-based salary components, i.e. bonuses.

The section at the heart of the new provisions is section 87(1) of the Stock Corporation Act. It prescribes the principles governing the payment of compensation to supervisory board members and, at the same time, imposes a legal duty on the supervisory board to ensure that compensation is in an appropriate amount (MünchKomm-AKtG/Spindler, § 87 marginal note 79). The section also contains specific criteria for determining the appropriateness of management board remuneration. To be appropriate, remuneration must be commensurate with the performance of the individual management board member and not exceed, without good reason, what is customary for the industry, size and country of the company concerned. In the case of listed stock corporations, the remuneration structure must be geared towards the sustainable development of the company. Variable remuneration components are to be determined using a multi-year performance base. Supervisory boards are obliged to agree upon possible limits for extraordinary occurrences.

As compared with the previous version of section 87(2) of the Stock Corporation Act, the amended version increases the authority of the supervisory board to reduce salaries if the stock corporation's financial situation deteriorates significantly. If it would be inequitable to continue to grant the compensation due to the deterioration in the company's situation, then the supervisory board is required to reduce the compensation with effect for the future; thus the previous requirement of materiality is no longer necessary (Hüffer, AktG § 87 marginal note 9). Furthermore, the supervisory board may also reduce a



manager's pension as well as other related benefits during the first three years following his retirement. If the supervisory board intentionally or negligently fails to determine the remuneration, the company will have a claim for damages pursuant to sections 116 and 93(2) of the Stock Corporation Act. This has now been clarified in section 116 sentence 3 of the Stock Corporation Act. Although section 116 sentence 3 only refers to section 87(1) of the Stock Corporation Act and thus to the determination of compensation, it would be reasonable to also regard failure to reduce inappropriate compensation pursuant to section 87(2) of the Stock Corporation Act as a breach of duty. If nothing else, the wording of section 87(2) of the Stock Corporation Act supports this view. Thus, the supervisory board has an ongoing duty to review the remuneration structure.

Finally, the significance of the new provision in section 107(3) sentence 3 of the Stock Corporation Act should not be underestimated: The option of having shareholders decide on remuneration, which used to be available, no longer exists. The decision on the appropriateness of management remuneration pursuant to section 87(1) and (2) of the Stock Corporation Act can no longer be delegated to a committee for a final review. It is now mandatory that it be decided by the full supervisory board.

4. OUTLOOK

Supervisory board members now face a growing catalogue of duties. These begin with the necessity for at least one supervisory board member to be personally capable of reviewing the accounts or audit of the annual accounts and extend to the duty to check the appropriateness of the management board's remuneration (whose breach will result in a duty to pay damages) and the duty to petition for insolvency if the company has lost its management. If one reflects on the considerably more flexible soft law of the Corporate Governance Code, which has in the past often anticipated legislative changes, it seems safe to assume that supervisory board members will be subject to additional statutory duties and responsibilities in the future.

In light of this development, the legislature must of course be prepared to consider whether it is still appropriate for the office of supervisory board member to be designed as a typical secondary position or whether it is in fact high time that the terms for the exercise of such office were adjusted to the stricter set of duties that apply. Thus, for example, it would be logical in view of the more stringent requirements that now apply to further restrict the maximum number of supervisory board posts that a person may accept pursuant to section 100(2) of the Stock Corporation Act (as the German Corporate Governance Code in section 5.4.5 sentence 2 already does in certain cases) or to increase the number of meetings the supervisory board must hold (section 110(3) of the Stock Corporation Act).

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PHILANTHROPY OR CRIME? THE LEGAL LIMITS TO SPONSORING AND DONATIONS BY STOCK CORPORATIONS

It has become standard practice for companies to support the arts, science, culture and sports through sponsoring and donation. In view of empty government coffers, the need for such private sector initiatives in these areas can be expected to increase in the future. At the same time, the management's use of corporate funds is now exposed to greater scrutiny, which is reflected in the growing number of investigations and prosecutions involving breach of trust. As a result, it is worthwhile taking a closer look at the aspects of corporate and criminal law involved in such acts of generosity on the part of stock corporations.

1. BACKGROUND: ENTREPRENEURIAL DISCRETION

According to section 76(1) of the German Stock Corporation Act (Aktiengesetz – AktG), the management is responsible for a stock corporation's conduct of business. In this context, the management may also exercise discretionary judgment. However, corporate officers must be guided by the interests of the company when exercising such entrepreneurial discretion. This notion of the interests of the company encompasses the aggregate interests of the various stakeholders, which may to some extent even conflict. Such interests include in particular those of the company's owners (shareholders), employees and creditors, but, by virtue of the social component codified in Art. 14(2) of the Basic Law (Grundgesetz – GG), also those of society at large or the common good. When making decisions involving discretionary judgment, the management must reconcile the above-mentioned interests to achieve an appropriate balance. Against this background, it is generally considered acceptable for the management of stock companies to authorize generous contributions to support the arts, science, culture and sports.

Accordingly, the following will regularly be considered permissible under corporate law:

- traditional sponsoring, which involves making money or monetary benefits available to persons, groups or organizations involved in sporting or cultural events or similar important public activities in such a manner as to achieve corporate objectives at the level of advertising or image-enhancing public relations at the same time,
- tax-deductible donations to non-profit organizations made with no expectation of receiving any direct benefit in return,
- philanthropy performed without regard to benefits and in some cases even performed anonymously.

It is hardly possible to distinguish clearly in an individual case between purely altruistic activities carried out exclusively for the benefit of society and major image-enhancing public relations activities that are intended to contribute significantly to the success of a company over the long term. Even contributions that are not made for immediately obvious advertising purposes may nonetheless serve the purpose of public relations since the company can simply mention them without giving details in the context of its press releases.

2. LIMITS UNDER CORPORATE LAW

The authority to dispense corporate generosity that derives from the responsibility of the management for the conduct of business is not, however, tantamount to unlimited discretionary judgment. Section 93(1) of the German Stock Corporation Act stipulates that the management must consistently exercise its entrepreneurial discretion with the care of a prudent and conscientious manager. Corporate officers must ensure that any voluntary decrease in corporate assets is made with the care of a person who controls monies that do not belong to him in a fiduciary capacity.

A company's officers cannot in any case be held liable for failure to properly exercise entrepreneurial discretion when making decisions if they could have reasonably assumed that they were acting in the interests of their company and on the basis of appropriate information in accordance with the business judgment rule embodied in the second sentence of section 93(1) of the German Stock Corporation Act. The Federal Court of Justice (judgment of 6 December 2001, 1 StR 215/01, NJW 2002, 1585) has defined the prerequisites for the admissibility of corporate donations – and the same is likely to apply in principle in the case of sponsoring – on the basis of the following concrete criteria:

RELEVANCE TO THE CORPORATE PURPOSE

The greater the discrepancy between a cause that receives support from a company and the purpose for which that company was organized, the narrower the discretionary judgment of the management becomes.

REASONABLE RELATIONSHIP IN TERMS OF EARNINGS AND ASSETS

Corporate donations must remain within the realm of the reasonable as measured in terms of the earnings and assets of the donor organization. In the scholarly literature, the outlays for charitable purposes considered acceptable under corporate law vary between from 1 to 2 or even 5% of dividends distributed. In view of the fact that the management must exercise discretionary judgment and take into account current corporate earnings and assets in the individual case, the establishment of such general limits would not seem helpful.

Assessment of what is reasonable can be particularly difficult when a company finds itself in a tight financial situation. According to the Federal Court of Justice, the management is not under any obligation to completely refrain from making corporate donations in those years in which the company operates at a loss. However, the court did state that the interests of a company do call for an especially diligent examination of corporate donation policy in the case of a permanent or longer-term deterioration of earnings performance.

INTERNAL TRANSPARENCY

The less the cause that receives support from a company has to do with the purpose for which that company was organized, the more stringent the requirements become in terms of internal disclosure and transparency of donations.

EXCLUSION OF IMPROPER PERSONAL INTERESTS

When making decisions regarding the choice of recipients and the amount of donations, corporate officers may not allow themselves to be guided by improper interests and in particular not by purely personal preferences. In the case of more sizeable donations that further the personal preferences or interests of an individual officer, that officer may not be allowed to make the corresponding decisions even if his position within the organization does generally include responsibility for donation policy.

LIABILITY OF THE MANAGEMENT FOR VIOLATIONS

In the event that a member of the management should exceed the bounds of his discretionary authority in a given case, this will constitute a breach of that member's duties under corporate law and make that member liable towards the company for damages pursuant to the first sentence of section 93(2) sentence 1 of the German Stock Corporation Act.

3. CRIMINAL ASPECTS

According to the Federal Court of Justice, not every violation of duty under corporate law can also be assumed to constitute a breach of duty in the sense of a breach of trust pursuant to section 266 of the Criminal Code (Strafgesetzbuch – StGB). A breach of duty under corporate law must be more serious to qualify as a criminal act. Whether a breach of duty of the management occurring in connection with a donation is serious is determined by an overall picture that takes into account in particular the aspects of corporate law mentioned above (lack of relevance to corporate purpose, unreasonable amount in terms of the earnings and assets of the company, lack of internal transparency, and the existence of improper personal interests). In any case, a breach of duty within the meaning of section 266 of the Criminal Code can be assumed to exist in connection with the donations only if all of these criteria have been met.

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EXTENSION OF THE LIABILITY OF THE MANAGEMENT OF PUBLICLY TRADED STOCK COMPANIES AND BANKS BY THE RESTRUCTURING ACT (RESTRUKTURIERUNGSGESETZ) AND IMPLICATIONS FOR D & O INSURANCE

The most recent legislative offshoot of the crisis in the financial markets is what is referred to as the Restructuring Act, which – insofar as can be told – is the keystone in a series of legislative efforts intended to stabilize the financial markets (Financial Market Stabilization Act (Finanzmarktstabilisierungsgesetz – FMStG) of 17 October 2008, Federal Law Gazette (Bundesgesetzblatt – BGBl.) 2008, page 1982, Financial Market Stabilization Amendment Act (Finanzmarktstabilisierungsergänzungsgesetz – FMStErgG) of 7 April 2009, Federal Law Gazette I 2009, page 725, Act for the Strengthening of the Financial Markets and Insurance Supervision (Gesetz zur Stärkung der Finanzmarkt- und der Versicherungsaufsicht – FMVAStärkG) of 29 July 2009, Federal Law Gazette I 2009, page 2305)). The Restructuring Act is an attempt to achieve this goal through the creation of new rules to govern the reorganization and restructuring of banks on the one hand (Bank Restructuring Act (Gesetz zur Reorganisation von Kreditinstituten – KredReorgG) and Restructuring Fund Act (Gesetz zur Errichtung eines Restrukturierungsfonds für Kreditinstitute – RStruktFG)) and through intervention in the regulatory apparatus already in place on the other hand.

This presentation addresses a change in the German Stock Corporation Act (Aktiengesetz – AktG) (section 93(6) of the new version) and the Banking Act (Gesetz über das Kreditwesen – KWG) (section 52a) that would at first glance seem innocuous as well as addressing the implications of this change for D & O insurance policies already in place. In this context, it is necessary to keep in mind that the term "bank" or "financial institution" as used in section 1(1) of the Banking Act does not imply any specific type of legal entity. As a result, what follows also applies to companies other than stock corporations if they operate as banks or financial institutions within the meaning of section 1(1) of the Banking Act.

The liability of the management of stock corporations for breaches of duty is based on section 93 of the German Stock Corporation Act, which also applies to members of the supervisory board of such companies due to the reference contained in the first sentence of section 116 of the German Stock Corporation Act. The Restructuring Act left the scope of the diligence duties of officers of stock companies unchanged. Executive officers and members of the supervisory boards of stock companies therefore remain liable for failure to discharge their duties with the care of a prudent and conscientious manager. However, claims arising from the breach of the duty of diligence now become time-barred after ten years instead of after five. According to section 52a(1) of the Banking Act, the same applies accordingly to the liability of managerial personnel, executive officers and supervisory board members towards banks and other financial institutions. Pursuant to section 24 of the Introductory Act to the Stock Corporation Act (Einführungsgesetz zum Aktiengesetz – EGAktG), the extension of the period of liability also operates retroactively. This applies for all claims for damages arising from breaches of duty that had not become time-barred as of the 15 December 2010, which is when the Restructuring Act went into force and effect. On the other hand, claims that had already become time-barred as of that time were not affected by the extension of the period of liability (which section 52a(2) of the Banking Act makes explicitly clear). According to the case law of the Federal Constitutional Court, no constitutional reservations exist in respect of retroactive application under these conditions.

This pseudo retroactive application does, however, result in a series of problems in connection with the insurance protection against such liability that officers and supervisory board members often enjoy. Executive officers and directors of larger stock corporations and financial institutions regularly insist that a clause be included in their service contracts that obligates their companies to take out what is referred to as directors & officers (D & O) liability insurance to insure them against personal liability for breach of duty. In most cases, this takes the form of a clause that entitles the officer or supervisory board member to "appropriate" or "usual" D & O insurance with a specific minimum coverage.

Unlike the usual liability insurance offered on the market, which provides coverage for all claims occurring during the term of the policy, most D & O insurance is based on the "claims made" principle. That means insurance coverage is provided only if the claim occurs during the term of the policy and is also reported to the insurance company during the term of that policy. In order to avoid situations in which executive officers or supervisory board members are exposed to liability after their terms of office expire and they no longer have insurance coverage, most D & O insurance policies make provision for what is referred to as an extended reporting period. In this case, claims relating to the term of the policy that are reported to the insurer prior to the expiration of the extended reporting period will also be covered. The extended reporting period and the period during

which claims may be brought before they become time-barred pursuant to section 93(6) of the older version of the German Stock Corporation Act usually coincide. However, extension of the period during which claims may be brought against officers and directors has resulted in the creation of a new situation that originally seemed to have already been resolved by the existence of extended reporting periods. It is now possible for executive officers or directors of stock corporations to commit a breach of duty while in office and then find themselves confronted with claims arising from such breaches when insurance coverage no longer exists because the extended reporting period has expired.

This scenario is likely to be least problematic for executive officers and supervisory board members who are currently still in office and whose service contracts entitle them to D & O insurance. As a general rule, the parties to such contracts will in fact not have agreed to a specific extended reporting period. This detail is usually regulated in contract practice through the use of the terms "appropriate" or "usual" in agreements. Both terms are of course susceptible to and require interpretation. When a service contract otherwise contains no provisions that are more specific, it can be assumed that the construction of what is to be considered "usual" or "appropriate" can change in the course of the term of the contract. When the Restructuring Act went into force and effect, it had already become no longer possible to consider D & O insurance with an extended reporting period of only five years as appropriate. The same is likely to apply in the case of the term "usual" in connection with a shorter reporting period since an extended reporting period of 10 years will very quickly become usual for new D & O policies as soon as the Restructuring Act goes into force. As a result, it is as a general rule possible to assume that the service contracts of such executive officers and supervisory board members entitle them to have the extended reporting periods of their D & O insurance adjusted accordingly.

This does not, however, apply in the case of former executive officers or supervisory board members, who may under certain circumstances find themselves confronted with a situation in which the reporting period for claims arising from breaches of duty is about to end. In such cases, it is likely to be much more difficult for such officers and directors to claim entitlement to a longer extended reporting period under their service contracts. This is not likely to be possible through interpretation of service contracts and the meaning of the terms "appropriate" or "usual" contained therein. Since the service contracts have already been terminated in such cases, the usual criteria for construction provided by the German Civil Code (Bürgerliches Gesetzbuch – BGB) will make it very difficult to base the interpretation of such contracts on factual circumstances that come into being only after the termination of the agreements. The only possibility here would then be the adaptation of the contractual agreement pursuant to section 313 of the German Civil Code on the grounds of interference with the contractual basis.

Section 313 of the German Civil Code is a legal formulation of the notion of good faith and permits adaptation of agreements that even goes beyond mere changes in wording. However, this is possible only if a "contractual basis," i.e., a circumstance tacitly assumed by both parties upon execution of an agreement without separate mention therein, either changes after execution or completely disappears. Without wanting to deal here in excessive depth with the standards required for the application of section 313 of the German Civil Code by case law and legal doctrine, there would definitely seem to be some question as to whether congruity of the period during which claims arising from breaches of duty may be triggered and the extended reporting period agreed with the insurer constitutes a circumstance that falls solely into the sphere of responsibility of the former officer or supervisory board member. It is generally acknowledged that circumstances that fall solely into the sphere of responsibility of one of the parties to an agreement cannot constitute a contractual basis within the meaning of section 313 of the German Civil Code.

A further consideration that is more of practical than legal relevance is that the stock corporation or financial institution affected is not likely to be particularly motivated to seek a potentially costly addition to a contract from its D & O insurer for the benefit of a former officer or supervisory board member. In the final analysis, the legal situation of former officers or supervisory board members in respect of the prolongation of the extended reporting period law is unclear and it is therefore difficult to foresee what legal position will ultimately prevail in the case law and scholarly commentary.

WOLF KANSTEINER

EQUITY-LINE FINANCING – A NEW FINANCING INSTRUMENT ON THE CAPITAL MARKET

Equity-line financings, which involve "standby equity purchase agreements," have become a popular way for publicly traded companies in the US to obtain financing. This alternative type of financing is also being used with increasing frequency in Germany. Many publicly traded stock corporations either cannot obtain financing or cannot obtain adequate financing. This can be due in particular to the overall economic environment or the situation in the industry in which a company is active. For example, it is currently difficult for companies involved in biotechnology to obtain outside financing. But equity financing can also involve pitfalls. It is not always possible to place new shares from capital increases optimally in a difficult stock exchange environment. And this is where equity-line financing can provide a solution.

Equity-line financing basically consists of the use of a structure that involves an investor who enters into an agreement with a publicly traded stock corporation to purchase new shares from authorized capital representing a previously agreed amount over a specific period (for example, three years) when requested to do so by the company. The company itself, on the other hand, may decide at its sole discretion whether or not to avail itself of the draw down rights it so acquires and, if so, to what extent.

Equity-line financing therefore involves draw downs agreed in advance and thus a series of capital increases from authorized capital. The issued capital of the stock corporation therefore gradually increases accordingly. This process continues until either the agreed commitment period expires or the aggregate volume agreed is reached. During this process, the capital increase takes place to the exclusion of preemptive rights of other shareholders and the aggregate amount is therefore limited. This amount may not exceed a total of 10% of the current capital stock. Since this available authorized capital is as a rule quickly "used up" and may prove insufficient to cover the aggregate volume of the issuing program, it is usual practice for stock corporations to have additional capital authorized by shareholders at each annual general meeting. This then again makes available an amount equal to 10% of the capital stock free of any preemptive rights. Immediately upon the registration of execution of each individual capital increase in the commercial register, i.e., after the creation of the new shares, the number of shares that can be publicly traded is increased within a specific period of time. As a result, the number of shares that can be publicly traded is gradually increased as is the amount of capital stock.

What at first sight seems tempting is in fact extremely complex in terms of the legal aspects involved. For example, the floor price, i.e., the price at which the new shares are sold to the investor, must exceed a certain amount. Investors have an interest in acquiring the shares at the lowest possible price in order to be able to

place them on the capital market at a profit soon thereafter. They will therefore attempt to secure the lowest possible floor price. Companies on the other hand would like to receive the highest possible price for their shares and limit the dilution of the equity held by their shareholders. It is likely to be usual to agree to a discount of from 3 to 5% on the average trading price of the shares during a specific period agreed to in advance prior to each draw down.

Caution is also called for when structuring fees. Investors will as a rule not be satisfied with a discount on the trading price, but also insist upon commitment and structuring fees for making the equity-line financing available. In this context, it is necessary to comply with the relevant provisions of legislation governing securities in respect of the acquisition and maintenance of capital.

Each individual draw down is in practice rather complicated. In particular, it is necessary to adhere to a rigid timetable that involves not only the court of registry but also the stock exchange, i.e., third parties. Since equity-line financing is likely to be familiar only to very few registry court judges, the possibility of requests for further information cannot be excluded. This can interfere with the rigid timetable and cause considerable inconvenience not only for the company but also for the investor if arrangements have already been made to issue new shares. As a result, it is recommended that the individual draw downs or increases in capital and the timetable be coordinated with the respective court of registry or stock exchange in advance.

All in all, equity-line financing may be complicated in terms of the legal aspects involved, but this alternative financing instrument can contribute significantly to the financial strength of publicly traded stock corporations if properly structured. Companies involved in the biotechnology industry have been at the cutting edge in this area in Germany and are already making use of this financing instrument. It is likely that further companies will follow their example.

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All in all, equity-line financing may be complicated in terms of the legal aspects involved, but this alternative financing instrument can contribute significantly to the financial strength of publicly traded stock corporations if properly structured.

LIABILITY ISSUES INVOLVED IN THE ECONOMIC REALIGNMENT OF PRIVATE LIMITED COMPANIES

I. INTRODUCTION

The private limited company is a form of incorporation that represents an extremely common way of structuring corporate activities and doing business. What makes this business form so attractive is that it can be used to exclude the possibility of personal liability on the part of shareholders and limit liability to the amount of share capital or corporate assets. In the case of violation of the provisions of law governing the legal formation of a private limited company (which are referred to as incorporation provisions), shareholders may, however, expose themselves to the risk of personal liability. It is the intent and purpose of the incorporation provisions to ensure the existence of the capital required by law and the articles of association to protect creditors when a company is created since this is ultimately what justifies the limitation of liability to corporate assets.

The treatment of the economic realignment of a private limited company is the same as that of the initial legal incorporation of a private limited company with the result that the provisions of law that the legislature has enacted to cover the creation of a previously non-existent legal person are applied accordingly in the case of the entrepreneurial realignment of a private limited company that already exists. According to the case law of the Federal Court of Justice, the incorporation provisions and the accompanying liability model apply not only to the initial legal incorporation but also in cases involving what is referred to as the economic realignment of private limited companies as well. Depending upon the individual case, this may entail a significant risk that the purchasers of a private limited company or, in the case of the realignment of a private limited company, previous shareholders will find themselves personally liable for the debts of a company despite the fact a decision to do business through a private limited company generally limits the liability of those involved.

II. ECONOMIC REALIGNMENT

The term economic realignment includes the acquisition of shelf or shell companies as well as resumption of business operations by a previously inactive private limited company under the same shareholders.

1. Acquisition of a Shelf Company

For present purposes, shelf companies are private limited companies that are established by providers of legal services. They have the legally required share capital and, as the name indicates, are offered for sale „off the shelf." Although the share capital has been fully paid in, no liabilities exist and the company has not been previous engaged in business activities, the acquisition of a shelf company is considered to involve the economic realignment of a private limited company (see Federal Court of Justice, order of 9 December 2002 – II ZB 12/02, NJW 2003, p. 892 and 893). In that respect, it is assumed in the case law that the private limited company is an inactive legal entity that becomes active upon acquisition (Federal Court of Justice, order of 7 July 2003 – II ZB 4/02, NJW 2003, pp. 3198 and 3199).

2. Acquisition of a Shell Company

The acquisition of what is referred to as a shell company also qualifies as economic realignment. This involves the acquisition of a private limited company that has suspended operations, i.e., a company that legally exists and has already been actively involved in the conduct of business in the past but had completely ceased operations by the time of sale to the purchaser. In this case, the private limited company would then resume business operations under the purchaser after acquisition (see the Federal Court of Justice, order of 7 July 2003 – II ZB 4/02, NJW 2003, p. 3198 and 3199). In practice, this type of economic realignment is of only marginal importance. The risk of also acquiring residual liabilities along with the shell is too great and unfathomable.

The acquisition of what is referred to as a shell company also qualifies as economic realignment.

3. Resumption of Business Operations by a Private Limited Company

As far as the case law and scholarly commentary are concerned, the term economic realignment also covers constellations in which an existing private limited company that has ceased operations in the past resumes its business operations again. In such cases, it is immaterial whether the resumption of business operations occurs in conjunction with a sale or change in shareholders in the meantime (see Munich Higher Regional Court, judgment of 11 March 2010 – 23 U 2814/09). In that respect, it is necessary to make a distinction here as compared with the restructuring or reorganization of a private limited company, which do not qualify as economic realignment, although it may be difficult to make this distinction in practice. The main reason why the restructuring or reorganization of a private limited company does not qualify as economic realignment is that the company has not suspended business operations although it may well have significantly realigned, expanded or restricted its activities (see the Federal Court of Justice, order of 7 July 2003 – II ZB 4/02, NJW 2003, pp. 3198 and 3200).

III. LIABILITY

1. Exposure to Liability

Classification of the acquisition of a shelf or shell company or resumption of business operations by a private limited company as an economic realignment means that the provisions of law governing the incorporation of a private limited company that are intended to ensure the existence of the subscribed capital of the company are applicable accordingly and that the acquisition of the company or the resumption of business operations with a view to actually providing the share capital of the private limited company becomes at the same time subject to scrutiny by the court of registry. As a result, the court of registry must be notified accordingly in the case of an economic realignment and the

managing director of the private limited company must confirm that the contributions to share capital described in section 7(2) and (3) of the Private Limited Companies Act have been made and that he continues to freely dispose of such contributions as required by section 8(2) of the Private Limited Companies Act (Gesetz betreffend die Gesellschaften mit beschränkter Haftung – GmbHG) (see the Federal Court of Justice, order of 9 December 2002 – II ZB 12/02, NJW 2003, p. 892). In the case of an economic realignment, as in the case of the initial legal incorporation of a private limited company, the confirmation of the managing director also serves to demonstrate that any losses already incurred by the company have not, entirely or even in part, consumed the contributions to share capital due or made by shareholders.

In the event the court of registry is not notified of the economic realignment of the private limited company – due to failure to appreciate the legal situation, omission on the part of the shareholders or other reasons, the shareholders then become personally liable with no limit in respect of either time or amount. In such case the conditions pertaining to liability that apply in the case of excessive debt when a private limited company is initially incorporated apply. The shareholders are then liable for the difference between the legally required or constitutive share capital and the actual value of the corporate assets as of the time of notification of the court of registry of the economic realignment. The liability of the shareholders covers the period from the time of acquisition of the shelf or shell company or resumption of business operations to the time of the notification of the economic realignment (according to the Munich Higher Regional Court , judgment of 11 March 2010 – 23 U 2814/09, with further references).

Finally, it is important to keep in mind that liability for excessive debt arising from failure to notify the court of registry of the economic realignment of a company is not limited exclusively to those shareholders who were directly involved in the process of realignment following either the acquisition of a shelf or shell company or resumption of business operations. The Munich Higher Regional Court recently ruled that even shareholders who acquire interests in a private limited company after economic realignment, i.e., from a private limited company that has already resumed business again, are liable for excessive debt. Whether or not a new shareholder had any positive knowledge of the economic realignment is irrelevant for the purposes of application of the principles of liability for excessive debt (see Munich Higher Regional Court, judgment of 11 March 2010 – 23 U 2814/09).

By analogy, section 11(2) of the Private Limited Companies Act also means that individuals acting on behalf of a company may be personally liable if they do so before the court of registry is notified of the economic realignment of that company. However, such liability is based on the assumption that not all shareholders have consented to commencement of business operations.

2. Limitation of Liability

Application of the incorporation provisions in the case of an economic realignment, and in particular the rules governing liability for excessive debt, entails a risk of significant exposure to personal liability for the shareholders of a private limited company although they will regularly have opted for incorporation in the form of a private limited company precisely to protect themselves against unlimited personal liability for the debts of the company. The principles governing liability in the case of an economic realignment that have been elaborated by the Federal Court of Justice in its case law to protect creditors do not in all cases do justice to the situations encountered in actual practice and may entail personal liability on the part of shareholders that is not always equitable. In that respect, it comes as no surprise that reservations have been expressed in the case law and scholarly commentary in respect of practical considerations and arguments advanced in favor of a limitation of liability in the case of the economic realignment of private limited companies.

a) In a judgment from the year 2009 that has not yet become final, the Chamber Court expressed its agreement with the opinion advanced here to the effect that the risk exposure of shareholders of private limited companies to liability due to the application of the incorporation provisions and the model for liability for excessive debt is in need of correction (see Chamber Court, judgment of 7 December 2009 – 23 U 24/09, NZG 2010, p. 387). The case brought before the Chamber Court for decision involved the question as to whether the shareholders of a private limited company should be held liable under the rules governing excessive debt due to failure to notify the court of registry of the economic realignment and failure on the part of the

managing director to submit the appropriate statement of confirmation required under section 8(2) of the Private Limited Companies Act although the share capital of the private limited company had been completely paid in by the shareholders when business operations commenced. The Chamber Court ruled that the shareholders were not liable for losses incurred after the commencement of operating activities under the rules governing liability for debt in the case of this constellation. The Chamber Court convincingly grounded its judgment, which runs counter to the rulings of other courts, arguing that the personal liability of shareholders in the case of the actual existence of the full amount of share capital when business was commenced could not be justified by the intent and purpose of application of the incorporation provisions in the case of an economic realignment, which is namely to ensure that capital is actually provided to protect creditors of the company (also according to Beck'scher Online-Kommentar GmbHG/Jaeger, section 3(43).

b) Like the Chamber Court, the Munich Higher Regional Court has also already recognized the necessity of limiting the risk of personal liability by shareholders in the case of the economic realignment of a private limited company and gives shareholders the possibility of escaping liability if they can prove that the constitutive share capital was covered by the corporate assets of the private limited company at the time of the economic realignment (see Munich Higher Regional Court, judgment of 11 March 2010 – 23 U 2814/09). In addition, the Munich Higher Regional Court has at least considered a suggestion from the scholarly literature that would limit the personal liability of the shareholders to the difference between the share capital pursuant to the articles of association and the actual amount of the corporate assets at the time of the registration of the amendments to the articles of association following the acquisition or reorganization (referred to as differential liability) (see Munich, judgment of 11 March 2010 – 23 U 2814/09; Ulmer GmbHG, section 3(166).

c) Finally, the Federal Court of Justice reaffirmed, in an order from the year 2010, its rulings on personal liability in the case of the economic realignment of a private limited company. At the same time it made it clear that there can be no question of personal liability if a private limited company commences business operations only after the usual start-up and lead times following its establishment and registration, but had already engaged in concrete activities to plan and prepare for the commencement of business operations as long as the business operations commenced thereafter remain within the scope of the purpose for which the company was formed pursuant to its articles of association (Federal Court of Justice, order of 18 January 2010 – II ZR 61/09, NZI 2010, p. 316).

IV. OUTLOOK

Experience has shown that entrepreneurs do not, in view of the mandatory application of the incorporation provisions along with the personal liability for excessive debt imposed by the Federal Court of Justice, automatically preclude the possibility of personal liability for the debts of the company by choosing to operate as a private limited company. As of now, it is still completely unclear whether the case law of the Federal Court of Justice, which has established extra-statutory legal obligations and grounds for liability in a manner that is tantamount to the creation of legislation, is even constitutionally without reproach and acceptable. This is all the more the case since provision has already been made elsewhere for the protection of the creditors of the registered company, which is the actual intent and purpose of such application of the incorporation provisions in the case of an economic realignment, namely through prohibition of covert dividends, rules governing liability for the destruction of a company and the liability of members of managerial and supervisory bodies. Legal practitioners will in the future continue to have a special obligation to advise their clients of the potential exposure to liability in connection with an economic realignment and avoid any occurrence of such liability through appropriate measures.

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