Made in Germany

Business Law Magazine

In this issue
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Dear Reader,

Brexit is not only keeping law firms busy, it is also a key topic that corporate lawyers are focusing on as well. That is why this edition of Business Law Magazine is examining common legal problems arising from the UK’s “good-bye” from the European Union. If cross-border mobility, IP law and commercial issues are on your professional agenda, don’t miss a single article in this issue.

Also in this issue, you can keep up to date on German corporate law, M&As and the recent hype regarding the blockchain technology. It’s all here waiting for you to read.

And in another note: Martina Seidl, General Counsel and Vice President of Legal and Commercial at Fujitsu Technology Solutions, and Michael R. Winkler, Head of Legal Corporate for Asia Pacific and Chief Operation Officer of Daimler AG’s legal department have joined our advisory board. – Welcome to the team!

Yours sincerely,

Thomas Wegerich
The good news about Brexit

Impact on cross-border mobility: UK companies relocating to Germany have approved and reliable concepts until Brexit takes effect

By Dr. Dirk Jannott, Petra Stoeckle and Peter Hocke

Background

The British vote to leave the EU is a source of great uncertainty for UK corporates doing business within the EU. Such multinational companies domiciled in the UK as Vodafone have started to think publicly about “relocating” their domicile to other EU Member States. A key driver for this consideration is uncertainty about the legal framework that will govern UK companies after the UK leaves the EU. In particular, this concerns the fundamental freedoms currently secured under EU treaties, including the freedom of establishment and to provide services and the free movement of capital. The agreements to be entered into between the EU and the UK in connection with Brexit will determine whether and to what extent equivalent freedoms and the legal frameworks supporting them (such as passport provisions in the financial services sector that foresee a “one-stop shop” with one regulator for the entire EU) will be available to UK companies after the exit.

The need to consider relocating the company’s domicile could also arise for smaller companies incorporated under UK law but that have their place of effective management in Germany. In particular prior to liberalization of minimum capital requirements for German limited liability companies in 2008, a large number of German entrepreneurs had established companies under UK law as companies limited by shares in order to benefit from the less strict capitalization requirements in the UK at that time. This development was facilitated by judgements from the European Court of Justice stating that the freedom of establishment requires German courts to recognize the legal capacity of a company incorporated in
another Member State irrespective of the company’s place of effective management. It is possible that – subject to deviating agreements – German courts may revert to requiring companies incorporated in the UK to have their place of effective management in the UK in order to be recognized as such. In a worst-case scenario, such a lack of recognition of a UK company by the German courts could even result in unlimited liability of the UK company’s shareholders.

Methods to relocate a company’s domicile to another EU or EEA Member State and timing

What methods are available for relocating a UK company to another EU or EEA Member State? The current legal framework provides, in principle, for four methods:

• Outbound cross-border merger
• Cross-border relocation of a European Company (Societas Europaea – SE)
• Cross-border transformation of an UK company into a company incorporated in another EU or EEA Member State
• Asset deal

With the exception of the asset deal, each of these methods is governed by European law and will (subject to potential deviating agreements or national legislation enabling companies to engage in cross-border relocations irrespective of their membership in the EU or EEA) therefore only be available as long as the UK effectively remains a member of the EU or, at least, the EEA.

In terms of timing, one may say that the UK has not yet even officially informed the European Council on its intent to leave the EU and that the actual exit is not likely to take effect prior to the end of 2018. Nevertheless, planning a relocation should not be set aside until the actual exit appears on the horizon as each of the methods available for relocation requires extensive preparation from an operational, tax and legal perspective.

Cross-border merger

Since the adoption of the Cross-Border Merger Directive in 2005 as legal basis for cross-border mergers of corporations within the EU, several mergers have taken place between UK corporations and companies located in different states of the European Union. As a reliable method for relocating, such cross-border mergers could be suitable for transferring all the assets and liabilities of a UK company to another Member State without the need for a liquidation process in the UK. If no existing entity is available or appropriate to serve as a transferee company, the shareholders of the transferor company would, in a first step, establish a new company in the chosen host Member State.

A period of at least eight to 12 months should be scheduled for such a cross-border merger. It is important to be aware that the merger not only has to be approved by a 75% majority of shareholders, but also, under certain conditions (and different from other Member States), by a majority in number, representing 75% in value, of the creditors present and voting at a UK creditors’ meeting.

Cross-border relocation of a European Company (SE)

The UK company could, in a first step, be transformed into an SE in accordance with the SE Regulation, however such a transformation requires the UK company to be a public limited company (PLC) and have had a subsidiary in another EU or EEA Member State for more than two years. If the UK company is a limited company (Ltd.) with a subsidiary in another EU or EEA Member State for more than two years, it has to be transformed into a PLC first, before the transformation into an SE is possible. If the UK company has not had a subsidiary in another EU or EEA Member State for more than two years, the transformation can be achieved by way of a merger with an (acquired) shelf SE.

Planning a relocation should not be set aside until the actual exit appears on the horizon as each of the methods available for relocation requires extensive preparation from an operational, tax and legal perspective.

Once the transformation into an SE is completed, the SE can, in a second step, initiate a cross-border relocation into another EU or EEA Member State by transferring its domicile. The SE Regulation explicitly provides for such an option. The relocation requires a transfer proposal and a respective report, each to be drawn up by the management, as well as an approving shareholders’ resolution with a qualified majority. A period of at least 12 to 18 months should be scheduled for the transformation of a UK company
into an SE and its subsequent relocation to another EU or EEA Member State.

**Cross-border transformation**

On the basis of judgements from the European Court of Justice, there is a strong argument that, from the perspective of European law, a cross-border transformation of a company incorporated in the UK into a company incorporated in another EU or EEA Member State is possible. In practice, this would be executed by way of transferring the UK company’s domicile to another Member State and incorporating the company in accordance with the laws of the transferee Member State. As a consequence, the company would not be dissolved and reestablished, but rather it would continue its existence. After the transformation, this would be in the legal form of the transferee Member State with the regulations of the transferee Member State now applying. This concept should be applicable for the UK until Brexit takes effect.

Due to a lack of practical precedents in the UK it is, however, doubtful whether a cross-border transformation will immediately be approved by UK authorities. Having to enter into disputes with the UK authorities would certainly create a more cumbersome process for cross-border transformations of UK companies than cross-border mergers, although continuation of existence may be more favorable for the company involved in terms of some aspects.

>>> **There is currently no visibility in terms of the post-Brexit legal environment governing cross-border relocations of UK companies to other Member States and vice versa.** <<<

With respect to Germany, inbound cross-border transformations from other EU or EEA Member States are recognized and have been implemented in practice. As these transformations are carried out on the basis of judgements from the European Court of Justice, registration of these transformations should be aligned with the relevant German Commercial Register. Subject to potential delays in obtaining required approvals by UK authorities, a cross-border transformation can, from a German perspective, usually be implemented within a period of less than one year.

**Asset deal**

On the basis of an asset deal, a UK company could transfer all of its assets and liabilities to an entity incorporated in another Member State. Although the asset deal is a well-established method for relocation, its most material disadvantage is that the individual transfer of agreements requires in principle the consent of the relevant contractual partners. This can make the asset deal a rather complex process, and it carries the risk that negotiations could result in less favorable contractual terms. The extent of required approvals by contractual partners is therefore one of the key considerations when establishing a timeline for the implementation of an asset deal.

**Conclusion**

Until Brexit takes effect, there are approved and reliable concepts for relocation. There is, however, currently no visibility in terms of the post-Brexit legal environment governing cross-border relocations of UK companies to other Member States and vice versa. If the UK were to join the EEA, all of the aforementioned relocation methods would, in principle, still be available after Brexit takes effect. Nevertheless, companies considering a relocation to another EU or EEA Member State on the basis of the methods governed by EU law should closely monitor political developments and take into account the timing required for such a measure in order to not be faced with a different legal environment as a consequence of Brexit prior to completion of the relocation.

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Impact of Brexit on IP rights

IP rights: The closer the post-Brexit relationship between the EU and UK, the less the impact on them – and vice versa

By Dr. Claudia Milbradt, Anja Schwarz and Yannick Frost

Since the United Kingdom has voted to leave the European Union (Brexit), we now face a period of legal uncertainty that will influence the landscape of European intellectual property rights. For at least the next two years, the UK will remain a full member of the EU, and no changes to any existing IP legislation are expected. As the exit of a Member State of the EU is a unique event so far, the impact on IP rights cannot be precisely predicted. It will depend on negotiations and agreements made by the UK and the EU.

In the following, the potential impact of Brexit on various existing IP rights will be summarized.

Patent rights

In terms of patents, Brexit will not influence the status quo. The UK is a member of the European Patent Convention (EPC), which is not linked to EU Member State status. European patent law and patent litigation will remain unchanged.

The European Patent, which is a bundle of national patents accessed through a central application process, will still be available through the European Patent Office (EPO).

What will be affected by Brexit lies in the field of supplementary protection certificates (SPCs). For certain limited types of inventions, primarily those from the pharmaceutical sector, the term of protection can be extended beyond the usual legal provision of 20 years. This derives from the idea that these products’ very long certification process, which runs during the term of protection, unjustifi-

ably restricts protection. The SPC IP right is governed by an EU regulation that will not automatically apply to allow the granting of SPCs after Brexit. To ensure the protection granted by SPCs post-Brexit, the UK could implement a national SPC regulation or opt in the European SPC IP right by joining the European Economic Area (EEA).

The day the UK leaves the EU, it will no longer be party to the relevant EU regulations that have created the European Trade Mark.

The most crucial impact of the UK leaving the EU can be observed in the process of implementing the Unified Patent Court (UPC), which constitutes the biggest reform in the history of European patent law. The UK is one of three remaining states that have yet to ratify the final UPC
agreements. It is likely the next largest Member State in terms of granting patents, Italy, will replace the UK as a ratifying party. Additionally, one of the three central division courts was to be based in London, but it seems improbable that it will remain in the UK capital now. At this time, the future of the UPC ratification process is unclear, and further delays are expected.

Registered trademarks and registered designs

Registered trademarks and registered designs are the most harmonized forms of IP rights in the EU, which means there will be a noticeable change in protection following Brexit.

The day the UK leaves the EU, it will no longer be party to the relevant EU regulations that have created the European Trade Mark. These rights automatically cover all EU Member States. Without any new implemented agreements between the UK and the EU, existing European Trade Marks and Registered Community Designs will no longer be valid. IP holders will, of course, be able to obtain protection for trademarks and designs through the national UK Intellectual Patent Office, but the impact on existing registrations will depend on the arrangements the EU and the UK agree on.

In the long term, European Trade Mark holders who make the majority of their use of those trademarks in the UK may find their European Trade Marks at risk of becoming vulnerable to revocation for nonuse in the post-Brexit EU. Similarly, it is unclear whether European Trade Marks that undergo some form of conversion into UK rights, but are not currently in use in the UK, will be able to continue to rely on previous use elsewhere in the EU.

There is another issue that could arise if the UK does not join the EEA: European Trade Mark owners would be able to restrict the trade of goods between the UK and EEA Member States as the trade would no longer “exhaust” the intellectual property rights. At this time, European Trade Mark owners cannot prevent the selling of their products if they had previously offered them on the market. If the UK were not a part of the EEA, the trade in products in an EEA Member State would not exhaust the trademark in the UK and the other way around.

Furthermore, the practical management of IP portfolios would change if the UK does not join the EEA. IP owners domiciled in the EU or under EEA jurisdiction do not need professional representation in proceedings before the European Intellectual Property Office (EUIPO). In contrast, parties based outside the EU or under EEA jurisdiction must be professionally represented for most proceedings.

Copyright and database rights

Copyright is a national right. This results in the fact that there won’t be any changes in copyright law during the two-year negotiation period after the UK formally declares its exit from the EU. The UK’s membership in the EU significantly shaped and influenced the Copyright, Design and Patents Act of 1988 (CDPA), but copyright is probably the least harmonized intellectual property right in the EU. It is unlikely that the UK will make significant changes to its copyright law. Even the aspects influenced by EU legislation are likely to remain.

In terms of database rights, the UK will need specific legislation for UK national database rights if the UK does not join the EEA. Database rights are a uniquely European intellectual property right that is only available to EEA nationals. The status is unlikely to be affected if membership in the EEA is negotiated.

License agreements

Brexit will not significantly influence usual IP practices regarding license agreements. Future license agreements will have to take into account the political and geographical changes resulting from the UK leaving the EU. When drafting contracts, the necessity of having to protect UK national IP rights has to be a focus, and useful arrangements have to be included. Current license agreements that do not have appropriate severability clauses will have to be renegotiated.

Concluding remarks

The impact of Brexit on intellectual property rights depends on negotiations between the UK and the EU. On the one hand, the UK could follow Norway’s example and remain closely integrated within the EU. The UK would become a member of the EEA and the European Free Trade Association (EFTA). As discussed above, EEA membership would positively affect legal certainty because most of the changes in IP law could be avoided. If the UK decides to choose the improbable path of breaking away from the EU completely, crucial changes in IP law will arise. In general terms, the closer the post-Brexit relationship between the
EU and the UK, the less the impact on IP rights.

IP holders should work hand in hand with their legal consultants to carefully monitor developments over the coming weeks and months to assess the impact on their intellectual property rights.
Before and after the big decision

Commercial and legal implications of Brexit: a 360º analysis

By Dr. Hanns Christoph Siebold and Dr. Mark C. Hilgard

On March 22, 2016, AmCham’s Financial Services Committee and the Corporate and Business Law Committee held a joint meeting in Frankfurt am Main at the offices of Squire Patton Boggs (US) LLP.

Dr. Jens Rinze, Partner at Squire Patton Boggs, and Sam Hill, CFA and Senior UK Economist at RBC Capital Markets, offered their insights on Brexit in a presentation titled “Commercial and legal implications of a Brexit: a 360º analysis.”

Now that the referendum on June 23, 2016, has actually resulted into a pro-Brexit majority, the aspects presented during the joint committee meeting have become even more relevant. In the article that follows, Rinze begins the analysis by demonstrating that the legal implications of Brexit are myriad and need to be considered for each industry and market participant from all relevant legal perspectives. Hill follows this examination with an economic analysis that addresses a number of commercial aspects of Brexit, starting with the issue of whether Brexit also means Smexit.

Legal implications of Brexit: an introduction

Brexit will affect all industries and have consequences for all companies and professionals situated in the UK and the remaining Member States (MS) of the EU (EU 27). It will also affect market participants situated in other countries around the world that hold interests in the EU or in EU-based entities. And Brexit will have consequences for all products and services produced within or distributed through the UK and EU 27.

In addition, Brexit will have consequences for the international treaties entered into by the EU, including, for example, the
more than 100 association agreements, free trade agreements, partnership and cooperation agreements and other international agreements (the most prominent international agreement being the Open Skies Agreement) because the UK is usually involved in such international agreements only in its capacity as a Member State of the EU; accordingly, such international agreements cease to apply to the UK once Brexit becomes effective and the UK ceases to be a Member State of the EU.

Article 50 of the Treaty on the EU

Article 50 (1) provides that each Member State of the EU can, in accordance with its own constitutional rules, decide to cease to be a Member State of the EU.

Article 50 (2) provides that the European Council needs to be notified of such a decision to terminate membership in the EU.

Article 50 (3) stipulates that should no such withdrawal agreement between the UK and the EU be concluded, the Treaty on the EU and the Treaty on the Functioning of the EU will no longer apply to the UK two years after receipt of the termination declaration from the UK by the European Council; accordingly, the UK will no longer be a Member State of the EU, and persons and companies domiciled in the UK and products and services originating from or distributed through the UK will no longer enjoy the status of being domiciled in or originating from or distributed through the EU.

This automatic termination rule following the lapse of two years after receipt of the termination declaration (unless unanimously extended) stipulates a well-defined cut for the legal consequences should no other rules be adopted.

Freedom of movement terminated

In principle, membership in the EU means that persons, entities, companies, products and services from Member States of the EU benefit from the principles of the free movement of goods, services, capital, establishment and persons within the entire EU.

Such rights of free movement within the EU not only mean that there are no customs borders, procedures and duties, but also that, in principle, mutual recognition prevails and that Member States are prohibited from directly or indirectly restricting the sale or distribution of goods and services and the movement of capital or persons or the establishment of subsidiaries, branches and other businesses by persons and companies domiciled in another Member State within their territory unless this is justified by important reasons that apply without discrimination to everyone and unless the relevant area is not harmonized through EU law.

As long as Brexit is not in effect, a banking institution or an insurance company established and licensed in the UK in accordance with the harmonized rules adopted on the basis of EU legislation cannot, for example, be barred from providing its services in all other Member States of the EU and cannot be barred from establishing branches or other businesses or subsidiaries in the other Member States of the EU. This will change once Brexit takes effect.

Rules of general application not directly relating to products and producers

In addition, an abundance of EU rules do not directly relate to the mutual recognition of products and producers, but are nevertheless highly relevant to the legal sector. Such rules include, for example, the EU Jurisdiction and Enforcement Regulation 1215/2012. This regulation would cease to be applicable in the UK as EU law should the UK cease to be a Member State of the EU; a consequence of this would be that judgements rendered by English courts would no longer be enforceable in the remaining Mem-
ber States of the EU in accordance with the rules set out by the regulation. The beneficiaries of court judgements rendered by English courts would have to go through the various domestic recognition proceedings stipulated by the domestic laws of the EU 27.

Furthermore, Council Regulation (EC) No. 1346/2000 of May 29, 2000, on insolvency proceedings and Regulation (EU) 2015/848 of May 20, 2015, on insolvency proceedings (which applies starting on June 26, 2017) would no longer apply in and with respect to the UK. This would mean that the mutual recognition of insolvency proceedings, the barring of a wide jurisdiction for secondary proceedings and the mutual recognition of acquired in rem rights would no longer be applicable with respect to the UK.

Contractual reference to EU persons, companies and products

As a final point, existing and future commercial agreements and other contractual arrangements that contain references to certain persons, counterparties, assets, products or services domiciled or licensed in or originated from a Member State of the EU need to be reviewed and adapted from the Brexit perspective. Apart from specific EU references in contracts, parties need to take into consideration the perspective of each applicable law chosen by the parties or the otherwise applicable general issues of customs duties, licenses, termination rights, increased cost provisions, margin calls, rights to demand placement of collateral, representatives and warranties, events of default and other rights and consequences that might be triggered by Brexit.

The Brexit files: the economics of the UK’s referendum on EU membership

There’s Brexit and then there’s Smexit: That’s Br(Itish)-exit from the EU and then the Single Market (S-M)-exit. As portmanteaus go, admittedly, the latter is not a linguistically aesthetic construction, but the Smexit question is one of the big ones when it pertains to the economic and market implications of the UK’s EU referendum on June 23, 2016.

When it comes to the economics of Brexit, Single Market access is seen to be the key factor. However, it appears difficult to avoid reaching the conclusion that it could take a long time, possibly up to two years, before the UK’s EU withdrawal agreement would emerge. The fear for markets is not just the uncertainty about future access to the Single Market in a Brexit scenario, but also the possible extended period of uncertainty about it.

During the time before any deal is reached, it is likely that markets will, temporarily at least, move to discount the scenario of an outcome a long way from full Single Market access, even if that doesn’t ultimately come to fruition. The consequences of this outlook for the economy and for financial markets are summarized below.

Given the circumstances described above, the speakers said they would adopt a scenario that sees the cost of the uncertainty about the post-Brexit UK-EU relationship resulting in the UK economy contracting by 2% to 4% over a two-to-three-year horizon, similar to some previous cyclical downturns.

Postponed investment decisions in light of the uncertain outlook and the subsequent consequences for employment and confidence are some of the channels through which economic costs would be expected to develop. The argument is strong against endorsing estimates at either extreme of the Brexit debate.

Sterling depreciation would be expected to cause a short-term spike in inflation, but in the longer term would more likely run the risk of undershooting the target as spare capacity opens up. A cut in the bank rate “toward zero” would be the first policy-easing option for the Bank of England, followed by a new round of Quantitative Easing (QE) gilt purchases to the extent further stimulus may be required.

For the rest of the EU, Brexit poses questions both about scope for more integration among euro-area members as their share of EU voting weight increases further, but also about the risk of other countries seeking new accommodations. On a country-specific level, Ireland is arguably most exposed with 15% of its exports going to the UK.

When it comes to the economics of Brexit, Single Market access is seen to be the key factor.

In an exit scenario with the economic shock outlined above, one primarily driven through the monetary-policy expectations channel, it could be appropriate for market participants to consider planning to anticipate the effects of a broad 10% to 15% move lower in the...
sterling exchange rate. The adjustment would be seen happening in weeks rather than months.

For the gilt market, lower risk-free real rates over a longer timeframe would be one factor pulling yields down, particularly with shorter maturities. But with another round of QE gilt purchases, the same reaction could be seen farther along the curve, too. Lower medium-term inflation expectations would also contribute to lower yields, with these effects seen to dominate upward pressure from credit considerations associated with cyclical deterioration in public finances.“

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The future of German codetermination

Supervisory boards in Germany: Are they facing a paradigm shift?

By Dr. Lutz Englisch and Dr. Mark Zimmer

July 1 this year marked the 40th anniversary of the German Codetermination Act (Mitbestimmungsgesetz). The act implements the rule of parity (that is, equal representation of shareholders and employees on a supervisory board), especially for German stock corporations (Aktiengesellschaften – AG), German private limited liability companies (Gesellschaften mit beschränkter Haftung – GmbH) and German limited liability partnerships (GmbH & Co. KG) with more than 2,000 employees.

The German One-Third Participation Act (Drittelbeteiligungsgesetz) allocates just one-third of a supervisory board’s seats to employee representatives and especially applies to German stock corporations and private limited liability companies with between 500 and 2,000 employees.

German codetermination legislation: the starting point

The German Codetermination Act was originally highly disputed, but has become an accepted part of corporate Germany in past decades due to attempts to balance the interests of shareholders and employees.

Nevertheless, the factual landscape in Germany has slowly but continuously experienced quite noticeable changes over of the last 10 years. As a result of the freedom of establishment (Niederlassungsfreiheit) as laid down by the Treaty on the Functioning of the European Union (TFEU) and formed by European Court of Justice case law, the number of German companies regulated by the Codetermination Act dropped from roughly 770 in 2002 to 635 in 2015. German companies have been evading the Act by adopting other legal forms: either the Societas Europaea (SE), which is more flexible in this respect than traditional German legal forms, or founding a company under English law but domiciling it in Germany. These entities have become more and more visible in Germany.

In light of the developing jurisdiction of the European Court of Justice in terms of the freedom of establishment for companies within the European Union, there has been increasing discussion in the German legal literature whether moving the administrative seat of a German company out of Germany and into another EU Member State could affect the applicability of German codetermination laws on such a company.

The current controversy ...

A recent legal development holds the potential to have a huge effect not only on German codetermination laws, but also far-reaching and practically important consequences on other EU Member States:

Previously, it was widely undisputed that only employees of companies domiciled in Germany that have the German legal form conclusively set out by German
Codetermination legislation would fall under these acts. The previously undisputed tenet was that employees of foreign subsidiaries of the German parent company did not count for purposes of determining the respective (2,000 or 500) thresholds under German codetermination laws or the size of the supervisory board. Correspondingly, it has always been self-evident that foreign staff members of EU subsidiaries outside Germany were not entitled to vote or be elected for a supervisory board seat.

These principles, perceived to be iron-clad laws, have now been tested in German courts in four different cases – and it looks as if the question about the territorial and personal reach of German codetermination laws will have to be decided by the European Court of Justice. Of the four cases recently brought before German courts, three are still pending, just one has been finally decided. The competent lower courts as well as the courts of appeals reached conflicting decisions and based them on different arguments:

Just a few months ago, on June 17, 2016, the Higher Regional Court of Frankfurt am Main decided by court order (No. 21W91/15) to stay proceedings in the matter of the composition of the supervisory board of Deutsche Börse AG until the European Court of Justice has decided on a different case, the TUI case, and to wait for the subsequent preliminary ruling from the European Court of Justice. In the first instance, the Frankfurt District Court (No. 3-16 O 1/14) had taken a different position and decided the Codetermination Act also calls for factoring in the workforce employed by subsidiaries of the German parent company in other EU Member States – for determination of both the relevant applicable threshold and the way to organize the respective supervisory board.

As mentioned above, the Higher Regional Court of Berlin (No. 14 W 89/15 – TUI) had deferred their decision to the European Court of Justice in a matter regarding the composition of the supervisory board of TUI AG. They did this to obtain a preliminary ruling, and presented their questions to the European Court of Justice as to whether the limitation on active and passive participation to workers employed in Germany would conflict with Article 18 and/or Article 45 of the TFEU, and so foreign EU employees of subsidiaries of German parent companies would not be entitled to vote for the supervisory board seats on the employee representatives’ side at the level of the German parent company. This case is now pending at the Higher Regional Court of Munich. As recently communicated by the Court, the procedural status of this case is not yet clear.

... and its consequences

What are the legal and practical consequences of these contradictory decisions and the current uncertainties resulting from this situation? The obvious and preeminent question is, of course, whether the German codetermination system is, in the eyes of the European Court of Justice, perceived to restrict freedom of movement and discriminate against employees from other EU states. If so, the follow-up question would be whether domestic codetermination systems of other EU Member States are also affected by such a ruling – and whether this could lead to a point when the EU Commission might consider taking action as part of its company-law agenda. At present, companies potentially affected are well-advised to carefully analyze their respective factual situations and their exposure in terms of the structure and size of their supervisory boards. This analysis might also include considering established structural measures to avoid the current legal uncertainties described above.

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A complex transaction

Separation of businesses: a strategic option for listed companies

By Dr. Robert Weber

Both nationally and internationally, the separation of businesses has developed into a growing trend. The most recent and most prominent German examples include the split-off of E.ON’s conventional energy generation business into Uniper and the spin-off of Bayer’s plastics business to Covestro, including the latter’s subsequent IPO. Prior to this, Siemens had already split off its lighting business into Osram; and a few years ago, Bayer had split off its chemicals and polymers activities into Lanxess. The separation of businesses is also a strategic option being exercised internationally. Examples include separation of the payment service PayPal from eBay as demanded by the activist investor Carl Icahn, separation of the Ferrari business from the Fiat Chrysler Group and separation of the Philips lighting business from Philips.

Background

Frequently, the reason for the separation of a business is the perception that full entrepreneurial potential can only be achieved by focusing on the company’s core business segments. The idea behind this is that two separate companies are able to act more dynamically and in a more focused way in a changed market environment. This also means improved diversification in terms of customers, technologies and risks. Different risk profiles attract different investors who can then target these business activities directly. The separated company has its own financial reporting and investor relations. In addition, the separated company will be less dependent on certain criteria for intragroup allocation of financing (such as strategic importance or synergy potentials for the entire group of companies). Remuneration for the staff of both companies can be better tied to the actual success of each business on the basis of tailored compensation plans, which makes it easier to find and retain qualified personnel.

On the other hand, separation of a business does (at least in the short term) have some drawbacks. There will be one-off costs for establishing two separate partial groups and, moreover, debt financing may have to be repaid at less favorable terms.

Alternatives

In Germany, there are, in principle, two alternatives available for such a separation: a split-off (Abspaltung) and a spin-off (Ausgliederung) with a subsequent IPO. These two alternatives differ as follows:

In the case of a split-off, the shareholders of the existing listed company receive certain shares on a pro rata basis in the new listed company holding the separated business, with these shares booked in the shareholders’ custody accounts. The advantages are obvious: The split-off can be implemented irrespective of the capital market environment, the remaining shares to be held by the shareholders of the existing or “old” company can be determined in detail and the typical transaction risks of a “classic” IPO or sale of a company can be avoided. On the other hand, the old company will not be provided with new liquidity.

This is different in the case of a spin-off with subsequent IPO. After the business division has been spun off into a sub-
sidiary, the listed parent company will initially hold all shares in the subsidiary. In the subsequent IPO, new shares in such a subsidiary can be placed with new investors, providing the subsidiary with liquidity that can, for example, be used to pay debts it owes to the parent company. The listed parent company will remain a shareholder of the listed (subsidiary) company at least for a certain period of time. It can further reduce its equity interest in the subsidiary by selling shares in the subsidiary in connection with the IPO or later on the stock exchange, which will provide it with additional liquidity. In the case of an IPO with a sale of shares, new investors will, however, have to be found for the subsidiary and this involves a placement risk that cannot be fully assessed in the current capital market environment.

**Implementation and pitfalls**

Implementing such a separation of companies requires time and much experience. The initial considerations and plans will be made by board members or will in any case be limited to a small group of persons. As soon as the plans become more specific, however, a larger project team will have to be set up. The members of the project team usually include persons currently holding functions at the existing company and persons who will hold specific functions at the new company to be established in connection with the separation in order to ensure that the latter’s interests will be appropriately safeguarded in the process. From a legal perspective, it is not only important to prepare the technical side of the split-off or spin-off with a subsequent IPO, but also to identify and address at the start of the project all major pitfalls that could cause the project to fail (such as joint venture agreements containing change of control clauses). In addition, uniform provisions governing liability and taxes will have to be developed irrespective of the national law applicable to each of the companies. Future cooperation between the companies will have to be defined and agreed in legally binding terms. The effects of the corporate restructuring will have to be considered not only for the period up to the date of the separation, but for the foreseeable future thereafter. Otherwise, unpleasant surprises may occur when corporate law measures are implemented at a later point, for instance with respect to taxes.

It is the project team’s task to establish the company group to be separated from the old company and to prepare the split-off or spin-off with subsequent IPO. Both processes flow seamlessly into each other. Under aspects of corporate law, this means preparatory measures under the Reorganization Act, contributions with noncash capital increases, individual transfers and, if necessary, retransfers of certain assets that are required before the actual split-off or spin-off and IPO can be implemented. The time for resolutions of the shareholders’ meetings of the companies involved and for drafting the contract documents and their review must be considered in a step-by-step plan that includes the approval procedure for the securities prospectus to be issued for the new shares. Debts need to be discharged and new collateral and sureties must be negotiated and issued. The company to be separated will leave the cash pool of the old company and a new cash pool has to be set up. Any existing control and profit-and-loss transfer agreements must be terminated and a completely new contract-based group relationship will have to be established within the company to be separated. And in a final step, the separation will also have to be negotiated and regulated with respect to the following, usually centrally managed, areas: IT, HR and accounting, insurance, pension plans, pension commitments, permissions, patents and trademarks, and the like. In addition, numerous special legal problems often arise and need to be addressed.

**Conclusion**

The separation of a business is a complex transaction requiring coherent project planning and project steering. A variety of factual matters and circumstances involving partially complex and difficult legal questions have to be resolved in a pragmatic and legally sound manner. It is absolutely necessary that, apart from having the required technical legal expertise, the legal advisers entrusted with steering the project also understand business issues. The further development of the business and the risks involved will have to be anticipated in order to maintain an optimal scope for taking action in the face of both legal and tax issues for both companies following the separation.

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When two cultures collide

Blockchain and the law: Regardless of the special technology’s success, the general trend behind it is not stoppable

By Dr. Nina-Luisa Siedler and Tom H. Brägelmann, LL.M.

Introduction

Everyone is talking about blockchain. Not a day passes without articles on new, revolutionary ideas. The technology that initiated this hype uses automated databases that store the “transactions” according to a particular set of rules and are intended to prevent any human intervention for unauthorized users. The databases are decentralized and stored in parallel on numerous servers. They allow updating only on the principle of consensus, which effectively makes any manipulation by hackers impossible. The basic idea is, in fact, very simple: a database for transactions that manages itself according to rules that have been set and is tamper proof. The idea originates from the inventor of the cryptocurrency bitcoin.

Many examples of applications for this technology can currently be found in the financial sector within the growing FinTech industry. One that deserves mention is the R3 consortium, which has gathered together more than 40 banks around the world to provide the global financial market with secure and fast solutions for payment transactions and securities trading. The Australian stock exchange is moving in the same direction with its appointment of an US company to use blockchain technology for clearing. Besides this, there are numerous consumer products, such as payment in local shops by means of smartphone wallet apps that are organized through the use of cryptocurrencies. With a view toward property transactions, Sweden has already seriously examined and run tests together with banks on the extent to which the land registry can be operated on the basis of a blockchain.

In the United States, the Financial Stability Oversight Council (FSOC) has recognized the blockchain technology as a valuable mechanism for improving market transparency in its recently published annual report for 2016. The breakdown of risk concentrations among those still currently involved in handling financial transactions (particularly banks and stock exchanges) is also regarded as attractive. The technology reportedly has the potential to minimize risks and improve the stability of the financial markets. At the same time, the FSOC points out that every new technology is associated with risks that the supervisory authority has to observe. Due to a previous lack of experience, circumstances might arise under which weaknesses would not be recognized until after the damage caused was already considerable. The necessity for closer cooperation among the international regulators was also identified, as potential market participants are likely to act across national boundaries.

Fragmentation

This is the common problem of the new technology, which basically functions...
on a technical level around the world: the fragmentation of the law. Worldwide, there are some 200 national states or jurisdictions. The UN alone has 193 members. Added to this are numerous multilateral trade agreements and other transnational bodies of legislation. Consequently, the situation quickly becomes unclear for purely Internet-based, global offers. Barely a single legal topic exists that is subject to globally uniform regulation. Areas such as data and consumer protection, in particular, as well as regulatory standards, primarily in the financial sector, are drafted in extremely different ways according to the region.

Regardless of how successful this special technology will be, the general trend behind it can no longer be stopped.

As a matter of principle, suppliers initially have to adhere to the law of their own home country. If they then offer their idea across borders, they also have to observe the law of the country they are supplying to the extent that the law contains binding regulations that cannot be waived through a contractual choice of law with the user. This makes a general worldwide offering of the idea practically impossible. The only course remaining for suppliers, therefore, is to initially limit themselves to individual, selected jurisdictions in which they have examined the law and tailored what they are offering accordingly and to then gradually expand when they experience success.

**Competition of locations**

Against this backdrop, a real location-oriented competition among jurisdictions has now flared up. So far, Germany has not become involved. The relevant German regulatory body, the Federal Financial Supervisory Authority (BaFin), does not tire of pointing out that there will be no “playground” with reduced regulatory requirements for these young enterprises. In contrast, the United Kingdom has already declared the rule of the sandbox principle and offers FinTechs a set of simplified regulatory rules. This represents a win-win situation for the state and FinTechs. While the FinTechs are able to take their first legal steps on the market, the supervisory authority gains specific insights into the technical processes of the transactions. Reducing regulations is balanced out by protective measures. These include, for example, an indemnity obligation on the part of the FinTechs to cover possible customer losses. In the meantime, the Dutch central bank has been examining the technology by allowing a test series of blockchain transactions to run in a closed system. In one scenario, the bitcoin environment of the year 2140 was simulated in order to predict how the blockchain will work after creation of the last bitcoin unit. Within the framework of the EU Parliament, the Economic and Monetary Affairs Committee has announced it is in favor of taking a wait-and-see approach so as to not nip development in the bud. Switzerland goes beyond this: members of the parliament recently pleaded for deregulation of the concept of client deposits under banking supervisory law. According to this, companies that accept deposits (like savings deposits at banks) in the form of cryptocurrencies will no longer to be treated as banks. It comes as little surprise that Switzerland is taking a pioneering role in this area. The country has traditionally been very proud of its independence and the tendency of the blockchain community to hold itself independent of prescribed local regulations fits in very well with this culture.

**Outlook**

The blockchain community has thus embarked on a path of globalization that current local laws are having difficulty managing. Regardless of how success-
ful this special technology will be, the general trend behind it can no longer be stopped. It is therefore important to examine this phenomenon and provide a legal basis for any undesired technology possibilities – if in doubt, across national borders.

Further progress will be observed with excitement. Or, better still, it will be actively and jointly shaped by a broad stratum of society.

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Balance sheet guarantees in German SPAs

The latest judgment of the Court of Appeal of Frankfurt am Main: an analysis

By Dr. Dirk Stiller

Judgments dealing with German SPAs (sale and purchase agreements) are very rare because the parties usually resolve disputes amicably or by (nonpublic) arbitration. That makes a recent judgment (26 U 35/12) of the German Court of Appeal (Oberlandesgericht) of Frankfurt am Main ("Court") even more important. The judgment deals with two topics that are relevant in almost every SPA negotiation: balance sheet guarantees and the consequences of purchaser’s knowledge of a breach. This article explains the decision and the consequences it has for the practice of M&A law.

Underlying facts

The judgment pertains to an independent performance guarantee without fault (the German equivalent of a representation and warranty) according to which the company’s annual statement (for the most recent financial year) was prepared with the due care of a prudent businessperson in compliance with statutory provisions and presents a true and fair view of the financial position and performance of the company. The purchaser proved that the balance sheet erroneously showed a profit instead of a loss and that certain provisions were either not made or not made in the correct amount.

Balance sheet guarantees and their legal consequences under German law

The grounds for the judgement partially align with the prevailing opinion expressed by German legal authors and courts. In other parts of the judgment, they are surprising. In particular, the Court held that the independent performance guarantee was to be considered a "hard" balance sheet guarantee.

A hard balance sheet guarantee is usually defined as a guarantee statement...
according to which the annual financial statement comprehensively and correctly discloses any and all liabilities and obligations, known or unknown. In contrast, a “soft” balance sheet guarantee is a statement indicating the annual financial statements comply with the principles of orderly accounting and with statutory provisions.

Considering this, it is surprising the Court held that the agreed wording qualifies as a “hard” balance sheet guarantee. It appears to be a semantic debate, but the interpretation of the Court has the consequence that the seller can be held liable for all actual and contingent liabilities irrespective of potential knowledge or fault at the time of preparing the balance sheet. The Court thereby extends the adjusting events period (Wertaufhellungszeitraum) through the end of the last oral hearing of the post-M&A litigation.

The judgments on the calculation of the compensation

There are two possible ways of calculating compensation for a breach of a balance sheet guarantee under German law. One is the concept of balance sheet replenishment (Bilanzauffüllungsmethode) according to which the annual financial statements would have to be replenished due to misrepresentation; alternately, the compensation could equal the amount of a hypothetical difference in the purchase price. The Court followed the prevailing opinion among legal authors and refers to the hypothetical impact on the purchase price. The seller will have to put the purchaser in the equivalent position as if he or she had been able to agree on a lower purchase price by knowing the real situation.

It is surprising the Court held that the agreed wording qualifies as a “hard” balance sheet guarantee.

This concept is dangerous for both parties. The seller bears the risk that he or she has to indemnify the purchaser for the misrepresentation with a multiple if the purchaser can prove that he or she had calculated the purchase price using the discounted cash-flow method or the multiplier method and, thus, the amount has to be multiplied. The purchaser, however, will often be negatively impacted by a lack of evidence (as in the case at hand). Further, the ground for this judgment leaves the question open as to whether the seller could argue he or she would have in no way accepted a lower purchase price because of competing bids in the M&A process.

Purchaser’s knowledge

In almost every SPA negotiation, the parties discuss the questions of whether and how the purchaser’s knowledge of a potential breach would release the seller from his or her liability. The parties usually exclude the statutory rule of Section 442 of the German Civil Code and replace it with a tailored solution. In the case at hand the parties did not expressly exclude Section 442 of the German Civil Code. The Court stated very briefly that the SPA was to be construed in a sense that Section 442 of the German Civil Code was (implicitly) fully waived. A purchaser should, however, not rely on this rather purchaser-friendly construction but rather insist on an explicit waiver.

Conclusion

The judgment here proves the theory wrong that representations and warranties today are not as important as the purchase price mechanism in an SPA. Instead, it shows that both aspects work together, and the sections “representations and warranties” require a high level of economic know-how from the parties and/or the lawyers. Both sides benefit from a clear and precise wording of the balance sheet guarantee. While joint documentation by the purchaser and the seller as to how the purchase price was determined does not appear very practical, the purchaser should maintain appropriate documentation. Sellers should expressly exclude any risk that they would have to indemnify the purchaser for a misrepresentation with the use of a multiple.

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