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Doing Business in Germany Bulletin:
M&A Up-date

September
2012

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Dear Reader,

We are delighted to present you with the latest edition of our „Doing Business in Germany Bulletin".

This edition of the Bulletin focuses on M&A-related topics addressed by our practice groups Corporate & Tax and Labour Law. Besides German legislation and court decisions, it also discusses decisions of the European Court of Justice. Of course, our transactional lawyers work closely with other practice groups such as Commercial, Litigation and Arbitration, Banking and Finance, Construction and Real Estate, IP, Competition and Communications and Public Commercial Law as well as our Civil Law Notaries. From time to time, we will also address transaction-related topics from these practice areas. We hope that you will find the information in this Bulletin helpful.

The contents of this Bulletin are intended for general information purposes only and do not constitute legal advice on any specific facts or circumstances.

Please do not hesitate to contact us if you have any questions, remarks or other feedback regarding the topics addressed in this newsletter or any other matters.

Yours sincerely,
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Freedom of Establishment in the Context of Cross-Border Conversions

In "VALE" (C-378/10), issued on July 12, 2012 the European Court of Justice (ECJ) ruled that the national law of a Member State may not preclude cross-border company conversions when domestic companies are allowed to convert.

Facts

A limited liability company established under Italian law, VALE Construzioni Srl ("VALE Construzioni"), intended to transfer its seat and its business to Hungary and asked to be removed from the Rome commercial register since the company's business in Italy would terminate with its transfer.

In order for the company to operate in accordance with Hungarian law, the director of VALE Construzioni and another natural person adopted the articles of association of VALE Építési, a private limited liability company governed by Hungarian law, and applied for the company to be entered in the competent Hungarian commercial register. In the application the representative stated that VALE Construzioni was VALE Építési's predecessor in law.

By virtue of Hungarian company law only companies established under Hungarian Law are allowed to convert and consequently VALE Építési's application for registration was rejected by the courts arguing that a company incorporated and registered in Italy cannot obtain registration in the Hungarian commercial register in the form requested as a company which is not Hungarian may not be listed as a predecessor in law.

The matter was referred to the ECJ for a preliminary ruling.

Judgment of the European Court of Justice

With reference to its earlier judgment, SEVIC Sytems (C-411/03) the ECJ held that "national legislation which enables companies established under national law to convert, but does not allow companies governed by the law of another Member State to do so, falls within the scope of Articles 49 TFEU and 54 TFEU"

The ECJ points out that such restriction of the freedom of establishment cannot be justified by the absence of rules laid down in secondary European Union law but only by overriding reasons in the public interest, such as the protection of interests of employees or the preservation of effectiveness of fiscal supervision. However, the Court held that no such reasons were to be found in the present case.

Furthermore, the Court notes that the applicable provisions governing the procedure of cross-border conversions can be found only in the national laws of the Member State of origin and the host member state since secondary law of the European Union does not provide specific rules for such operation. Those national legal provisions must be applied in accordance with Articles 49 TFEU and 54 TFEU.

Consequently, it is for the host member state to determine the national law applicable to cross-border conversions. In this context a Member State is particularly entitled to apply its national law on domestic conversions as long as the respective national provisions comply with the principles of equivalence and effectiveness. In the VALE case the ECJ found the Hungarian authorities' refusal to list a non-Hungarian company as the converted company's predecessor in law to contravene the principle of equivalence if such record is made for the conversion of domestic companies.

Moreover, the principles of equivalence and effectiveness preclude the host Member State from refusing to take due account of documents obtained from the authorities of the member state of origin during the registration procedure.

Impact

The VALE judgment of the European Court of Justice promotes cross-border mobility for EU companies and once again is a clear statement against general differences in treatment depending on whether domestic or cross-border matters are at issue.

Even though the ECJ made clear that the existence of specific rules of secondary European Union law cannot be made a precondition for the implementation of the freedom of establishment, crossborder conversions call for common rules which determine the procedure of such operations. The respective national provisions still lack harmonization and, at this stage, cannot provide for the required level of legal certainty for entrepreneurs to effectively benefit from this newly gained corporate mobility.

In its VALE judgment the EJC itself had pointed out the usefulness of European rules for facilitating cross-border conversions and thereby gave new momentum for the requirement of a European Directive.

Transfer of GmbH Shares under Condition Precedent – Federal Court of Justice puts an End to the "Double-List-Model" and strengthens Acquirer's Rights

When the German Federal Court of Justice was concerned with the assignment of shares in a German private limited liability company subject to a condition precedent in its decision of September 20, 2011, the court finally outlined the scope of § 16 para 3 of the Law on Limited Liability Companies ("GmbHG"):

Background Information

Before fulfillment of such condition precedent the buyer cannot be listed as new shareholder in the shareholders list as he has not yet acquired ownership in the respective share. Consequently, the seller is still recorded as lawful owner of the share sold regardless of the fact that he is no longer authorized to dispose of this share.

Since implementation of the MoMiG, GmbH shares can be acquired in good faith if the seller has been incorrectly registered in the shareholders list as owner of the respective share for at least three years in order to protect a buyer of shares in a German GmbH from the risk of hidden intermediate assignments by the seller. However, this possibility of bona fide acquisition of shares created substantial risks for buyers who acquire shares under a condition precedent as the assignment of such share cannot be disclosed by entering the buyer as new owner in the list of shareholders.

In order to protect those (first) buyers from subsequent (secondary) bona fide acquisition of their shares, not only legal practitioners promoted the entry of a remark in a separate column in the shareholders list as possible means of protection. Although no amendments were to be made to the list of shareholders, such entry was meant to reveal the sale of share subject to condition precedent and to announce the future change in ownership (so called "double-list-model" / "Zwei-Listen-Modell").

Judgment of the German Federal Court of Justice

In the case to be decided by the Federal Court of Justice, the inclusion of a "new" shareholders list submitted by the notary had been rejected by the competent commercial register. The list was identical to the previous list as regards to the shareholders listed but contained a remark referring to the sale of a certain share subject to condition precedent as mentioned above.

The commercial register argued that the list did not record any actual changes in ownership of shares in terms of § 40 GmbHG. The decision of the commercial register was subsequently upheld by both, the court of first instance and the court of appeal.

The Federal Court of Justice confirmed the previous courts' findings and put an end to the discussion whether or not disclosure of such sale is necessary to protect the first buyer's legitimate interests:

The Federal Court of Justice held that German law does not provide for bona fide acquisition of a share already assigned under condition precedent. The first buyer is protected from such subsequent sale by the principle of priority stipulated in § 161 para 1 of the German Civil Code ("BGB").

In view of the shareholders list a (second) buyer may only rely on the seller's position as shareholder, however, the list does not convey any information on the seller's power to dispose of the listed share or the existence of certain encumbrances of such share. Consequently, a potential second buyer cannot successfully invoke his reliance on the correctness of the shareholders list as regards the seller's power to dispose.

Consequences

The first buyer of a GmbH share is sufficiently protected from intermediate bona fide acquisition of the respective share by a second buyer until the condition precedent of the primary sale is fulfilled.

However, the moment the condition precedent is fulfilled, the sale becomes effective and title of ownership passes to the buyer. Once the transfer took effect, the first buyer's situation is no longer different from any other sale of share, consequently, (after three years of incorrect registration) he is no longer protected from a subsequent bona fide acquisition unless the new shareholders list that lists the buyer as new shareholder has been submitted to the commercial register in accordance with § 40 GmbHG.

Failure to Disclose „Economic Re-Establishment" of a GmbH (Judgment of the Federal Court of Justice dated March, 6, 2012)

Background

The initial formation of a private limited liability company („GmbH") is completed with its entry in the competent commercial register. However, regardless of the company's former "legal establishment", the courts recognize the possibility of "economic re-establishment" of a GmbH („wirtschaftliche Neugründung").

Economic re-establishment concerns the reactivation of companies, which are already registered but economically inactive. It follows from the court's established case-law that in the event of economic re-establishment, the legal provisions governing the formation of a GmbH must be applied accordingly. As a consequence, the re-establishment of a GmbH must be disclosed to the competent commercial register including the managing director's assurance regarding the undiminished availability of the statutory share capital.

Particularly relevant in this regard is the re-activation of so-called "shell companies" („Mantelgesellschaften") and shelf companies" („Vorratsgesellschaften").

Shelf companies are formed for stock and are meant to be sold pursuant to their formation as a legal entity but without any operating business. In other words, the business of a shelf company is started only after the company's economic re-establishment.

Shell companies, by contrast, used to have an operating business which may, in the worst case, have reduced the company's existing share capital significantly.

When the buyer of a shelf company starts business activities his obligation to notify the commercial register of the company's economic re-establishment is obvious.

On the other hand, it may be hard to determine on a case-by-case basis whether or not the re-activation of such company does indeed constitute an "economic re-establishment" and is hence to be disclosed as such to the commercial register. Certain factors such as substantial amendments of the articles (e.g.name, seat or purpose of the company), transfer of shares or changes in the person of the company's managing director may indicate but cannot reliably determine a company's "economic re-establishment".

As regards the failure of such disclosure, its consequences for the personal liability of shareholders have been controversially discussed. Especially with regard to earlier judgments of the Federal Court of Justice it remained unclear whether shareholders were actually at risk to personally cover for any loss without restriction or whether instead personal recourse would depend on the question whether or not the statutory share capital had actually been available by the time of the company's economic re-establishment.

Judgment of the Federal Court of Justice:

In its recent judgment, the Federal Court of Justice rejected the idea of unrestricted personal liability of shareholders for the reactivated company's obligations and clarified the consequences of failure to disclose a company's economic re-establishment:

Facts

A limited liability company had been formed and registered in 1993 and started its business activities. In 2003 no assets were held by the company and it discontinued its business before it was reactivated by its shareholders in 2004. In this context the articles of association were amended (e.g.name, seat and purpose of the company) and a new managing director was appointed. Any amendments were filed for registration with the competent commercial register before the company started its (new) business, but the economical re-establishment of the company was not revealed.

In 2007 the company became insolvent and the appointed liquidator claimed full coverage of the company's losses from the sole shareholder by reference to the non-disclosure of the company's re-establishment in 2004.

Findings

In its judgment, the Federal Court of Justice confirmed the previous decision of the Higher Regional Court as regards the lower court's findings on the company's economic re-establishment in 2004 but limited the shareholder's personal liability to "liability for the impairment of share capital" ("Unterbilanzhaftung").

Consequently, shareholders can be held personally liable only to the amount of the value difference between the nominal amount of the existing share capital and the statutory share capital at the time of re-establishment. In case the statutory share capital does exist at the time of the company's economic re-establishment, shareholders are entitled to reject payment on these grounds, regardless of failure to disclose the economic re-establishment.

Consequences

Whereas the financial risk may be rather low when the economic activation of a shelf-company is concerned, the re-establishment of shell-companies may still involve substantial financial risks as shell companies usually have a "record of business activity" which may have resulted in a significant reduction in the company's share capital. Potential buyers must be aware that in any case of economic re-establishment the existing liabilities of the re-established company may trigger personal liability of the shareholders.

Hence, even though the Federal Court of Justice has restricted the liability risk in favour of the shareholders, in any case of (re-)activation of an inactive company, potential buyers are well advised to duly review a company's business activities.

German Transformation Act, Reform in 2011

After the second reform of the German Transformation Act which finally provided for the participation of German enterprises in cross-border mergers within the EU, especially stock corporations ("AG") benefitted from the third reform in 2011 which effectively pulled down bureaucratic barriers, and relieved financial burdens for reorganizations of enterprises in Germany.

Background

Particularly group mergers have been simplified: in case all shares of the transferring entity are owned by the absorbing entity, the preparation of a merger report is dispensable and a shareholders' resolution may be waived.

Squeeze-outs among stock corporations (and partnerships limited by shares ("KGaA") have been facilitated by lowering the minimum shareholding requirement from 95% to 90% where a stock corporation intends to merge with another stock corporation. In this case, the parent company may first force out all of the minority shareholders of its subsidiary and then proceed with the merger under the simplified requirements of a merger of a wholly-owned subsidiary. The above does not apply to mergers with a subsidiary in the form of a GmbH. For all other squeeze-outs, a 95% shareholding is still required. This threshold also applies for a squeeze-out under German Securities Acquisition and Takeover Act which has priority over a squeeze-out under the above described transformation rules.

By providing for electronic transmission of documents as well as electronic notification of shareholders and waiver of a special interim balance sheet, the preparation of shareholders' meetings of stock corporations has been substantially simplified.

Last but not least, the reform shaped opportunities for financial savings, for example by providing for audits pursuant to the provisions of the German Transformation Act and the Stock Corporation Act to be executed by the same expert.

Prospects

The adaption of the Transformation Act in accordance with the European Directive 2009/109/EC was another considerable step to a modern and internationally orientated business law; however, as international mobility of companies remains an ongoing concern, further modification of the national legal provisions will be only a matter of time.

No Visa Requirement for Non-EU Managing Directors

Already in 2009 the Higher Regional Courts, Duesseldorf and Munich ruled that neither a visa-free status nor the issuance of a permanent visa may be made a precondition for non-EU citizen to become managing director of a limited liability company. Under German law, any obstacles to the appointment are listed in § 6 para 2 of the Law on Limited Liability Companies ("GmbHG") and the Higher Regional Court Duesseldorf tends to the view that this provision does indeed define such obstacles conclusively.

Since the revision of the Law on Limited Liability Companies, German enterprises are entitled to transfer their administrative management seat to any country. Managing directors are hence free to operate the company's business from abroad since today's technical means provide for unlimited cross-border communication and secure appropriate performance of their statutory duties.

However, prior to the transfer of a company's administrative management seat, shareholders should keep an eye on possible tax consequences.

Extraordinary Termination of Organschaft (Decisions of the Higher Regional Court of Munich and the Tax Court of Lower Saxony)

Background

Under German corporate and trade tax law, a group taxation ("Organschaft") requires the conclusion of a profit and loss participation agreement (PLPA) between a parent company and one or more of its subsidiaries which must be properly executed for a minimum period of five years. Early termination will usually result in a retroactive disallowance of Organschaft and thereby in substantial negative tax consequences. However, German tax regulations provide for certain qualifying reasons for an extraordinary termination prior to the end of the 5-year period without any negative effect on Organschaft for the period completed so far. One of the accepted reasons is a sale of an Organschaft subsidiary. However, due to different legal requirements under tax and corporate law, early terminations in case of the sale of a subsidiary require proper planning under both, tax and corporate law in order to avoid that the intended effect of a saving of the Organschaft for prior years is jeopardized. For example, it is highly recommended to clearly stipulate the sale of a subsidiary as a reason for an extraordinary termination in the PLPA since other than the German tax regulations, German case law on the corporate law requirements would usually not allow for such an early termination unless clearly specified in the PLPA. With the two court decisions described in more detail below, both, a civil law court as well as a tax court have now put certain limitations on the justification of an extraordinary termination due to the sale of a subsidiary.

Decision of the Higher Regional Court of Munich (OLG München) of June 20, 2011

A PLPA has been agreed for the required 5-year minimum but it provided for the possibility of an extraordinary termination for cause in case of insolvency (bankruptcy) of one of the parties, gross negligence or intentional contract violations, or if more than 50% of the shares in the Organschaft subsidiary were transferred to a third party. After two years, the sole parent of the subsidiary resolved on the dissolution of the subsidiary and on the same day terminated the PLPA with reference to the dissolution resolution with immediate effect for cause. With an additional separate termination letter, the parent also based the termination of the PLPA on the argument that its own financial existence would be at risk if the PLPA would be continued due to the expected substantial losses during the upcoming liquidation period. The commercial register refused to register the dissolution resolution and argued that the dissolution of an Organschaft parent if resolved by its sole shareholder would not justify a termination for cause.

The OLG München confirmed the commercial register's rejection. It laid out that an extraordinary termination requires that the continuation of the PLPA needs to be unacceptable to one or both parties and that would not be the case if the sole shareholder without obvious justifying reason resolves on the subsidiary's dissolution. As to the second termination, the court agreed that – as suggested in legal literature – the threatening of financial destruction might justify an extraordinary termination. However, those requirements would by far not be met as the losses from a PLPA are generally foreseeable and constitute a typical risk for an Organschaft parent. The OLG München did not see any reason why the losses in the relevant years would not have been foreseeable at the time of the conclusion of the PLPA and argued that especially a sole shareholder would be in the position to substantially influence the financial success of its subsidiary.

Decision of the Tax Court of Lower Saxony (FG Niedersachsen) of May 10, 2012

In this case, the PLPA between two corporations provided for an extraordinary termination in case of the sale of the shares in the subsidiary. After less than two years, the parties of the PLPA agreed on an amicable termination as of the end of the fiscal year. Thereafter, the Organschaft parent sold its shares in the subsidiary to the German holding company of the group. That holding company was (indirectly) held by the ultimate parent company in the UK through a Dutch interim holding. The restructuring was based on the argument that otherwise a negative tax impact from the applicability of the UK rules for controlled foreign companies (cfc-rules) could not be avoided. In a tax audit of the Organschaft parent, the justification for an early termination for cause was denied and the Organschaft was treated as non-existing right from its beginning. The FG Niedersachsen confirmed the tax audits' view and denied the existence of a qualifying reason for an extraordinary termination of the PLPA. It argued that if the sale of the interests in the Organschaft subsidiary always qualified as good cause, the minimum period of an PLPA within a group of companies would be in the full discretion of the members of that group. That would contravene the legislature's decision to require a minimum period of five years to avoid a switching in and out of Organschaft at any time.

Also the negative consequences from the applicability of the British cfc-rules was not regarded as a reason for an extraordinary termination. The court argued that even at the time of the conclusion of the PLPA, the overall tax burden of the group which is one of the major requirements of the applicability of the cfc-rules was close to the respective ceiling. The exceeding of that ceiling was only caused by a reduction of Dutch tax rates which should have been foreseeable and not really surprising for the parties of the PLPA.

Consequences

The above two court decisions show that both, under German corporate as well as German tax laws, an extraordinary termination of the PLPA prior to the completion of the 5-year minimum period may not be based upon internal decisions to continue or discontinue a business or to restructure a group unless that results into a sale of the majority interests in the Organschaft subsidiary to a third party. It is highly recommended that prior to the entering into a PLPA, not only the potential tax savings but also the financial prospects of the subsidiaries in question including the overall tax structure of the entire group are thoroughly reviewed.

Non-Deductibility of VAT for Advisory Fees in Connection with Tax-Exempt Sale of Shares (Federal Tax Court Decision of January 27, 2011)

Background

Typically, VAT charged by suppliers is deductible for a German business which itself renders taxable services to its customers. Such qualifying revenues are either subject to German VAT (i.e., the company charges German VAT on top of its invoice amount to its German customer, or it is exempt from VAT, e.g., because the customer is a foreign business). However, if the company only renders taxable, but tax-free services (such as certain banking businesses or insurance businesses), it is also not entitled to claim VAT deductibility (or at last not in the percentage of its tax-exempt revenues).

Decision of the Federal Tax Court

In its decision of January 27, 2011, the Federal Tax Court had to decide on the deductibility of VAT charged to the seller of a parent company which was generally entitled to a full VAT credit due to its taxable revenues in the course of its ongoing business. The sale related to a 75% interest in a subsidiary (GmbH). The parent company had claimed deduction of VAT on invoices charged by its investment bank and by its law firm in connection with the sale of its interest in the GmbH. The Federal Tax Court denied a VAT deductibility due to a direct connection of the services rendered by the investment bank and the law firm with the tax-free sale of the 75% interest in the GmbH. Generally, the sale of shares is a taxable transaction under German VAT law, however, it is exempt from VAT under section 4 No. 8 lit. f. of the VAT Code (UStG) which exempts the trading of company interests. Due to this direct connection to the tax-free sale, the fact that the selling parent company was generally engaged in the rendering of VAT-taxable revenues did not count.

Exceptions from the above Non-Deductibility of VAT

In many cases, the above described decision will not apply to the VAT paid by companies which have sold their shares in a subsidiary if one of the following circumstances applies:

a) The seller has opted out of the VAT exemption as provided for under section 9 UStG. This requires that the seller is a taxable business (other than, e.g., a private seller), and that the acquirer agreed (which he will only do if he is entitled to a full VAT credit).

b) A sale of 100% of the interests in a subsidiary (other than, e.g., only 75% in the aforementioned case) qualifies as a so-called sale of an entire business ("Geschäftsveräußerung im Ganzen") which according to section 1 (1a) UStG is not subject to VAT at all (i.e. other than a taxable transaction which is only treated as tax-free under section 4 UStG).

c) In case of an "Organschaft" with a profit and loss participation agreement ("PLPA") where the Organschaft subsidiary will be sold and the buyer intends the continuation of an Organschaft for VAT purposes, as long as the majority of shares (resulting into a financial integration in the new Organschaft parent company) is transferred.

Recommendation

Unless one of the above described three exemptions applies and the non-deductibility of VAT for services rendered in connection with a tax-free sale of shares is likely, the potential tax loss may be limited by a respective invoicing from the service providers by which a distinction is made between services directly connected with the tax-free sale and other services which are deemed to be connected to the ongoing taxable revenues of the seller.

Notarization of GmbH Share Transfer Deeds by a Swiss Notary

Background

It goes back to 1980 when the German Federal Court of Justice decided that the notarization of a transfer of German GmbH shares by a notary in Zurich, Switzerland, was valid and to be accepted under German law. The court argued that notarization in Zurich is considered to be equivalent to a notarization in Germany. In the following this has been confirmed by other court decisions not only for the canton of Zurich but also for Basel and Zug. Notarization in those cantons became very popular especially as, depending on the underlying value of the transaction, the German fees to be charged by the notary based on a statutory fee table are substantially higher than those in Switzerland, especially in certain cantons where fees can be negotiated.

However, this common practice was challenged by German commentators as well as by an obiter dictum of the District Court of Frankfurt in 2009 based on a change of German law on limited liability companies back in 2008. The change in the law provides for the obligation of a notary who was involved in a transaction which has caused a transfer of ownership in GmbH shares, to issue a new shareholders' list reflecting that change which he must also file with the commercial register. According to the Frankfurt district court and many German notaries, that change in the law should have put an end to notarizations by foreign notaries as the obligation to issue and file the shareholders' list could not be imposed on foreign notaries.

Ruling of the Higher Regional Court of Düsseldorf of March 2, 2011

The Düsseldorf court held that a foreign notary like the notary in Basel acting in that case could still validly notarize a share transfer under German law and also issue the new shareholders' list. It further verified that the filing of the shareholders' list with the commercial register – which can only be done electronically based on a respective certified registration of the notary – could also be done by a German notary acting as a messenger of the foreign notary.

Consequences

The decision of the OLG Düsseldorf gives a more reliable basis for notarizations in Switzerland or in other European civil law jurisdictions. Of course, as long as the Federal Court of Justice has not decided on this issue, a certain risk will remain. However, it does not seem very likely that without any such limitation spelled out in German law, the Federal Court of Justice may hold that the recording of share transfers would now be limited to notarization by German notaries. That would also hardly be in conformity with EU law since notarizations in other EU Member States would be affected.

In practice, it is highly recommended to contact the competent commercial registers in advance in order to obtain their prior approval on the acceptability of a Swiss or other non-German notarization of the contemplated transaction. In our experience, the commercial registers are accepting Swiss notarizations from the above-named cantons for the transfer of GmbH shares as well as for the related new shareholders' list. They even tend to accept other notarizations such as those under the German Transformation Act ("Umwandlungsgesetz"). However, an undisputed exception, where notarization is strictly limited to German notaries, is the transfer of title to any German real estate.

Tax Treatment of an Amended Purchase Price due to an Amended Earn-Out Clause in a Share Purchase Agreement (Federal Tawn of May 23, 2012)

Background

Since a decision of a Federal Tax Court in 1993, it has been clear that amendments to a purchase price due to earn-out clauses in an originally agreed share purchase agreement (SPA) would be treated as an amendment of the initial purchase price with tax effect in the year, when the initial purchase price was taxable, i.e., amendments had retro-active effects as long as the underlying terms had already been laid out in the initial purchase agreement. That is also the case if the facts which have triggered the amendment of the purchase price only materialized at a time after the date of the sale, e.g., based on revenue or profits goals set for future years.

The decision of May 23, 2012

In the underlying case, the original SPA included an earn-out clause related to the future performance of the company. In the May 2012 decision, the Federal Tax Court ruled that the additional payment under the agreed earn-out clause had no retroactive effect on the purchase price but was taxable as additional purchase price in the (later) year of its payment. The reason was that in the initial earn-out clause it was only agreed that the seller would have an option right for the conclusion of an amendment to the purchase agreement if certain thresholds were met. Once that requirement was fulfilled, the parties actually agreed on an amendment to the purchase price agreement based on which the additional purchase price payment became due. That amendment was seen as the legal basis for the additional price.

Consequences

This decision shows that the drafting of the earn-out clause is decisive for the qualification of any later payments. To ensure that additional payments under an earn-out clause qualify as an amendment of the initial purchase price, the earn-out clause needs to include all requirements and consequences of an additional payment which may then be calculated just by applying a pre-determined formula to future results or other elements which were agreed in advance in the initial earn-out clause. Any later amendments to the purchase price other than the actual application of the agreed formula will bear the risk that the additional payment will not have a retroactive effect on the initial purchase price but will become only taxable in the year of payment.

Tax Treatment of Due Diligence Costs for a Discontinued Acquisition (Lower Tax Court of Baden-Württemberg, Decision of October 24, 2011; Appeal before Federal Tax Court Pending)

Background

There are controversial court decisions and opinions in legal literature about the question which advisory costs (such as lawyers' fees and accountants' fees) in connection with a contemplated transaction (acquisition or sale) are to be treated as directly deductible business expenses or to be capitalized as acquisition costs or allocated to the sales proceeds. Based on previous decisions of the Federal Tax Court, the line has to be drawn at the point in time when the general decision for an acquisition has been made. This means that expenses related to the finding of potential acquisition targets including industry studies and presentations prepared by M&A advisors would usually be regarded as directly deductible business expenses whereas the expenses for a letter of intent and especially for due diligence of the target are to be treated as additional acquisition costs. The argument that a prudent businessman would only finally decide on the acquisition once the due diligence report has been made available to him is not likely to succeed.

Decision of the lower Tax Court of Baden-Württemberg of October 24, 2011

In this case, the potential acquirer of a business claimed the deduction of due diligence costs as an immediately deductible business expense with the argument that during the due diligence the acquisition failed and was not completed. As a consequence, the taxpayer recorded the costs as directly deductible business expenses. In contrast, the tax authorities treated such costs as incidental acquisition costs with a subsequent extraordinary wright-off as a result of the failed acquisition which, however, was treated as non-deductible for tax purposes and therefore did not reduce the taxable income.

The tax court, however, ruled that the costs incurred in connection with the not completed acquisition cannot be considered as additional acquisition costs because in fact no shares were acquired. The tax court argues that also section 8 b (3) of the Corporate Income Tax

Code („KStG“) does not apply for the reason that no shares were acquired. This section disallows the deduction of expenses in connection with acquired shares which can be sold tax-free.

Prospect

The case is currently pending before the Federal Tax Court and it remains to be seen whether the decision of the lower tax court of Baden-Württemberg will be upheld.

Excursus: Deductibility of Real Estate Transfer Tax (RETT)

In its decision of April 20, 2011, the Federal Tax Court ruled that RETT incurred due to a consolidation of shares which indirectly results into a transfer of more than 95% of ownership in German real estate is not to be capitalized as additional acquisition costs for the acquired shares but rather immediately deductible as a business expense. Other than in case of a direct acquisition of shares in a real estate owning company the RETT from such an indirect transfer of ownership in real estate is only based on a fictitious acquisition and not a real acquisition of real estate under civil law principles. In prior years, several state tax courts had decided that also in cases like this, RETT would have to be treated as additional acquisition costs.

ECJ expands Scope of Transfer of Undertakings and Acquired Rights based on Seniority (C-108/10 of September 6, 2011 - Scattolon)

Background

Ms. Scattolon was a cleaner employed by the local authority in Italy working at a state school. Under Italian statute, her contract of employment was transferred to the state and due to that transfer, her salary was now based on a state collective agreement rather than the previous local authority collective agreement. Ms. Scattolon was then placed by the state on a salary scale which resulted in a salary as close as possible to her previous salary which corresponded to 9 years of service with the state. Ms. Scattolon wanted to be placed on a salary scale reflecting her 20 years of service with her old employer and brought an action against the state.

Putting her on a scale for 20 years of service under the state scheme would have resulted in an increase of her previous compensation.

This case has raised two important questions: Does the Transfer of a cleaning job from a Local Authority to the state qualify as a Transfer of Undertaking under the Acquired Right's Directive?

Neither the Directive nor the respective laws of the member states directly apply to the transfer of administrative functions from one public authority to another one. The European Court of Justice (ECJ) resolved that issue by declaring that cleaning services as well as other services outside the tasks of public authority were activities of an economic nature and would thereby qualify as an "economic entity" which may be transferred under the Directive.

Furthermore, the Directive requires a contractual transfer such as a purchase agreement or a transfer under a transformation act (e.g., a merger agreement). In other cases, the ECJ ruled that also a transfer of employment based on the decision of a public authority would qualify. In the underlying case the court now clarified that also a transfer by statute is to be interpreted as covered by the Directive.

Seniority Rights and Protection against a Set-Back of Employment Conditions

In earlier decisions, the ECJ has confirmed that the length of service with a former employee does not as such constitute a right directly resulting in any claims against the new employer. Instead, the length of service may only determine certain rights of the employer under provisions which are linked to seniority. However, the ECJ now also clarified that the transferee must take into account the entire term of service of the employee transferred and apply that number of years in accordance with the terms applicable at the transferee's business. The ECJ further takes the position that the transfer to a new employer governed by the legal provisions of another collective agreement may not result into terms of employment overall less beneficial than those with the old employer. This constitutes a major change as up to now the ECJ's position has been that the terms of a previously applicable bargaining agreement would only be guaranteed if the new employer is not bound by a bargaining agreement at all, whereas if he is, the new employer's bargaining agreement would replace the old one.

Consequences under German Law

The Scattolon decision leads to the effect that the requirement of a contractual transfer of an economic entity has lost its relevance nearly completely. Except for a transfer by inheritance, there is probably no remaining exception from section 613 a BGB. Furthermore, it appears that the ECJ is heading not just for a protection of transferring employees against a deterioration of their terms of employment but rather for an improvement. However, it remains unclear, how to measure a comparison of the overall benefits of the old versus the new collective agreement. In cases where the conclusion would be that the new terms are less beneficial, the benefits under the old collective agreement may then become part of the transferring employees' individual employment agreement, but it is then another open question if later amendments to the old collective agreements – whether to the better or to the worse from the employee's perspective – will also apply. Overall, the ECJ's decision confirms that in this area surprises are always to be expected.

Separation Agreement with the Seller of a Business to be Transferred only valid in Case of Final Separation (Decision of Federal Labour Court (BAG) of August 18, 2011)

Background

The German provision regarding the protection of employees in case of a transfer of business (§ 613 a BGB) ensures that generally, in case of the sale of the business or transfer by way of the German Transformation Act (Merger), an employee's employment contract would transfer to the new employer at unchanged terms. A termination by the old or the new employer due to the transfer of the business is void. Such a termination may, however, be allowed if it is based on independent reasons. A separation agreement between the old employer and the employee by which the employee enters into an amicable agreement on the discontinuation of his employment with the transferring business is valid.

Decision of the Federal Employment Court of August 18, 2011

The underlying case involved a company in insolvency proceedings (i.e., bankruptcy) where the appointed administrator reached agreement with the works council on the creation of structures for continuation of employment as well as a reconciliation of interest and social plan. For this purpose, a new employment and qualification company (EQC) was formed. It was agreed that the employees of the insolvent company should be provided with irrevocable offers for entering into a three-party agreement with the insolvent company and the EQC. The plaintiff in this case was presented with six alternative offers which involved termination of employment as of March, April, May, July, August or September 2006 corresponding with an offer for a limited term employment with EQC as of several alternative dates. On March 24, 2006, plaintiff signed all of those six draft offers which by then were neither signed by the insolvency administrator nor by EQC. The administrator and EQC finally signed one of the agreements which provided for a termination as of May 31, 2006 and start of employment with EQC as of June 1, 2006. The date of these signatures was left open. On May 8, 2006, the plaintiff entered into an employment contract with a new acquirer of the business, which had been presented to him as well as all other employees. On the next day, defendant acquired the assets of the insolvent business. On June 23, 2006, plaintiff signed a separation agreement with EQC effective June 1, 2006 at 24:00 hrs. In 2008, the defendant terminated the plaintiff's employment agreement for operational reasons by observing a one-month notice period. Plaintiff filed an action and claimed observing of a five-month notice period based on his years of service with his old employer.

The court held that the agreements between the employee, the insolvency administrator and the EQC only intended to create the impression of an interim employment with EQC which had interrupted the employment with the transferor and the transferee of the business. In fact, the employees never really worked for the EQC and even the formal employment was only in place for one day. The Federal Labour Court argued that the separation agreement was only entered into in combination with the prospect of employment with the transferee which had been bindingly agreed upon with the works council. The only open question was whether the selection by lot of 352 out of 452 employees for a final continuation of employment would actually be in favor of the individual employee (which was true for the plaintiff). Since by then, the transferee had already bound itself to actually employ 352 employees, the court regarded this offer as insofar binding. Overall, the entire complex structure of offers and separation agreements was only made in order to amend the employment terms and thereby circumvent the protection under section 613 a BGB. Therefore, the initial separation agreement was void and the plaintiff's action for observing a 5-month notice period based on his acquired seniority with his old employer was successful.

Consequences

Disregarding the complexity of the underlying facts produced by the administrator and the new employer, they could not circumvent the employee's protection under section 613 a BGB. Whereas termination due to independent business reasons (such as a reduction of work force due to discontinuation of a business line) may be valid in section 613 a situations, continuation of employment by the new employer without maintaining the employee's acquired rights is not an option.

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September
2012

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