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EMPLOYERS DO NOT ALWAYS HAVE TO LOSE AT THE GAME OF DOMINOES

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Good news for employers: A new Federal Labor Court decision will result in less risk for employers when terminating employees for operational reasons. Employers have long—and justifiably—criticized the complex and strictly construed rules they must observe when terminating employees for operational reasons. Whether an employer was able to follow these various rules to a T often involved not only extensive planning, but also a bit of luck.

TERMINATIONS IN GERMANY

In Germany, an employer may terminate an employee for three reasons:

- The employee's conduct (*e.g.*, intentional refusal to work);
- The employee's personal characteristics (*e.g.*, extensive absenteeism due to illness); or
- Operational reasons (*e.g.*, the employer must lay off employees due to a downturn in business).

(For Americans, it seems odd that an employer generally cannot terminate an employee based purely on an employee's poor performance.)

In essence, German law requires employers to consider employees' personal and family situations when deciding which employees to terminate.

THE "SOCIAL SELECTION" PROCESS

If an employer terminates some, but not all, of the employees for operational reasons, that employer must implement a "social selection" process to ensure that it terminates the "correct" employees as required by law. This means that an employer must terminate employees with "weaker" social factors before terminating those with "stronger" social factors.

What are the employees' social factors? They are as follows:

- Age;
- Years of service;
- Number of dependents; and
- Whether the particular employee is disabled.

Under German law, younger employees without dependent children are generally deemed to be less in need of protection against losing their jobs than are older employees who have dependent children. In essence, German law requires employers to consider employees' personal and family situations when deciding which employees to terminate. Though, as discussed below, employers are given a bit of leeway when deciding which employees to terminate, failure to consider the social factors properly will jeopardize the validity of the terminations.

For example, is a 42-year-old father of three children, who has been employed for only nine months, more in need of protection against losing his job than a 55-year-old single man without children, who has been employed by the company for 10 years? Not an easy question to answer.

Off the bat, it would not seem too difficult to apply the rules properly. However, as many employers that have terminated employees in Germany for operational reasons can attest, there is a big difference between theory and practice.

STEP 1: CATEGORIZING EMPLOYEES

When terminating employees for operational reasons, an employer's first step must be to determine which employees must be compared with one another. The law states that employees who are "comparable" in terms of their job duties must be compared. For example, if an employer wishes to terminate four of the company's 11 software engineers, two of its 16 salespeople, and three of the five employees in accounts receivable, the employer must weigh the social factors of these employees against those of the other employees within their respective departments.

Unfortunately, it is not always clear whether a particular employee is, in fact, "comparable" to another employee because employees' duties evolve over time and many people's jobs cross over into other departments. However, even if the employer classifies the employees into specific groups properly, that employer has only cleared the first hurdle.

STEP 2: WEIGHING THE SOCIAL FACTORS

The employer's second step is to ensure that it weighs the employees' social factors correctly. This requirement often places employers in an unenviable position. For example, is a 42-year-old father of three children, who has been employed for only nine months, more in need of protection against losing his job than a 55-year-old single man without children, who has been employed by the company for 10 years? Not an easy question to answer.

In an effort to simplify matters, many employers use a point system, whereby they will award points to each employee based on the employees' social factors. For example, each employee will be awarded one point for every year of

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service, four points for every dependent child, five points for a disability, and one point for every year in terms of the employee's age. Using the point system, the "comparable" employees will all be ranked, with the employee with the most points (*i.e.*, the one most in need of protection against losing his job) at the top of the list and the employee with the fewest points (the one with the weakest social factors) at the bottom of this list. Use of the point system is quite commonplace in Germany, as it introduces some objectivity to an otherwise rather subjective process. Further, if the works council agrees to the employer's point system, there is a much lower risk that a court will uphold a legal challenge to the weighing of the social factors.

STEP 3: EXCLUDING "CRUCIAL" EMPLOYEES

To the delight (or relief) of employers, an employer may exclude particular employees from consideration for termination if those employees have know-how or experience that is of particular importance to the company. Accordingly, an employer is not required to terminate a particular employee merely because that employee has "weak" social factors. Though employers certainly like to take advantage of the right to exclude important employees, this factor also complicates matters, since the question often arises whether a Labor Court will agree with the employer's conclusion that a particular employee could properly be excluded from the social selection process.

THE DOMINO EFFECT

If a Labor Court does not agree with the employer's social selection process, this could jeopardize the validity of many of the terminations. This has always been the crux of the problem: If an employer makes a *single* mistake during the social selection process, either at the stage of:

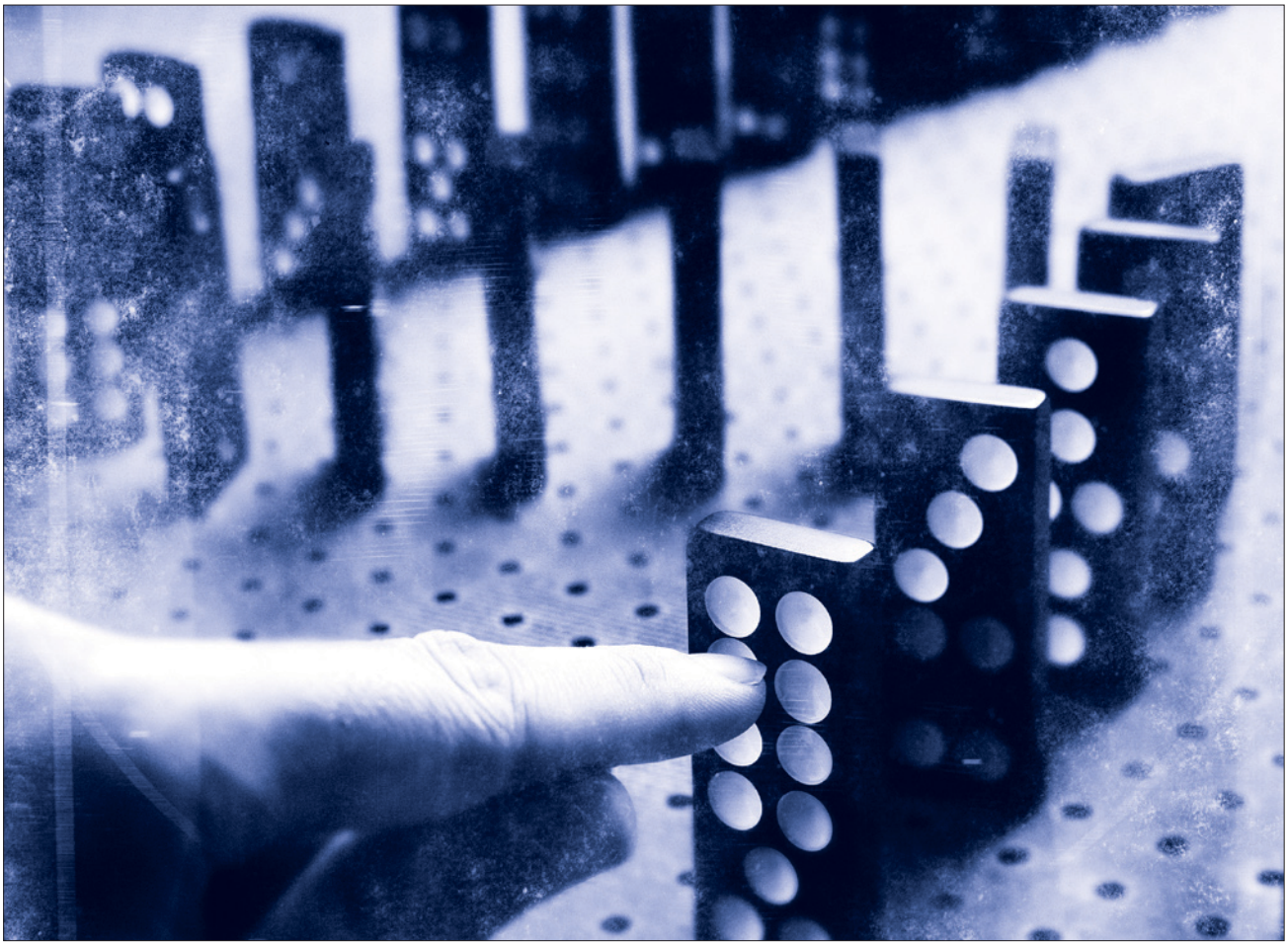
(i) Categorizing the employees into separate groups of "comparable" employees;
(ii) Weighing the comparable employees' social factors; or
(iii) Excluding particular employees due to their perceived importance to the company;

this jeopardizes the validity of the termination of all employees who had fewer points (if an employer uses a point system) than the one employee with whom the employer had made the mistake. If an employee challenged his termination based on the argument that the employer applied the rules incorrectly when issuing his termination, this often resulted in a "domino effect," whereby every employee who had fewer points than the individual to whom the employer applied the social selection process incorrectly had a proper cause of action, causing the court to invalidate each of those terminations.

Jones Day's German Labor & Employment Practice Continues to Expand

Jan Hufen joined Jones Day as an associate in the Munich Office's Labor & Employment Practice this past October. Jan studied law at Ludwig-Maximilians University in Munich and at the University of Passau, Germany. He focused on labor and employment law during his academic tenure and gained experience as a law clerk at a large law firm in Europe. After studying for one year at King's College in London, he graduated from the University of Cape Town in South Africa with an LLM, focusing on commercial law.

Jan advises on individual employment law issues as well as labor law matters, including pension issues. In addition, he works together with the Mergers & Acquisitions Practice in terms of advising on employment and labor issues as they arise in connection with corporate transactions.



The Federal Labor Court finally acknowledged that the burden was simply too great for employers. In a press release dated November 9, 2006, the Federal Labor Court stated that it will no longer apply this domino principle.

FEDERAL LABOR COURT'S RECENT DECISION

The Federal Labor Court finally acknowledged that the burden was simply too great for employers. In a press release dated November 9, 2006, the Federal Labor Court stated that it will no longer apply this domino principle.

In the above-referenced case, an employer had terminated six employees using a point system. The employer had erroneously awarded five extra points to a particular employee so that this employee was mistakenly not terminated. Each of the employees who had fewer points than this one employee filed an action arguing that their terminations were invalid because the employer had made a mistake with respect to the one employee. This argument met with success at the Court of Appeals level since that court applied the domino theory.

Though the Federal Labor Court only remanded the matter back to the Court of Appeals, it does appear from the Federal Labor Court's press release that effective immediately, only one employee may challenge the incorrect application of the social selection process — specifically, that employee who should not have been terminated had the

The Federal Labor Court's new method will also add some predictability—and thus reduce financial risk—when employers terminate employees for operational reasons. One practical effect will also be that employers will be more apt to exercise their right to exclude employees with special skills or know-how from the social selection process.

employer applied the social selection rules correctly. Not every employee with fewer points will be able to challenge his termination, because the employer's mistake actually impacted only one employee directly, *i.e.*, the one who was erroneously terminated. The other employees would still have been terminated despite the mistake, as they did not have a sufficient number of points to avoid termination.

Though this case before the Federal Labor Court concerned a mathematical error rather than the incorrect application of the more subjective categorization of employees, it is fair to assume that the Federal Labor Court will uphold a challenge to a termination only if the challenge is filed by those specific employees who can argue that the employer's mistake made the difference between being terminated and not being terminated.

WHAT DOES THE FUTURE HOLD?

This change in stance by the Federal Labor Court is, of course, welcomed by employers, as the oft-criticized domino theory will no longer raise the ire of employers who may have made an honest mistake during the complex social selection process. The Federal Labor Court's new method will also add some predictability—and thus reduce financial risk—when employers terminate employees for operational reasons. One practical effect will also be that employers will be more apt to exercise their right to exclude employees with special skills or know-how from the social selection process. Many employers were wary of exercising this right as they knew the risk was quite high that an employee who had not been excluded from consideration from termination and was subsequently terminated would challenge the employer's determination. It then always came down to whether the Labor Court agreed with the employer's reasoning when excluding particular employees.

FEDERAL LABOR COURT PUTS GREATER PRESSURE ON EMPLOYERS WHO SEEK TO EXTEND TEMPORARY EMPLOYMENT AGREEMENTS

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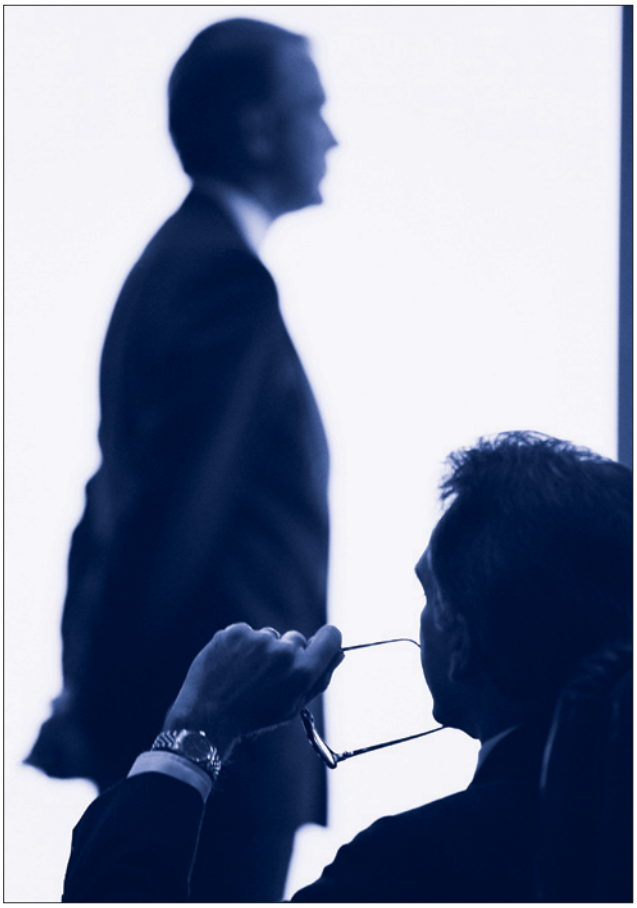
Temporary employment agreements often take on a life of their own in Germany. These agreements are governed by the Part-Time and Temporary Employment Act. According to this statute, employers must distinguish between temporary arrangements concluded for an "objective reason" and those that are not based on an "objective reason."

TEMPORARY EMPLOYMENT AGREEMENT – IS THERE AN OBJECTIVE REASON?

According to the Part-Time and Temporary Employment Act, temporary arrangements are specifically permitted as long as they are based on legally valid grounds, often translated as an "objective reason." An objective reason exists if there is an actual reason for the employment arrangement to be temporary. Examples include seasonal work, if an employee covers another employee who is on maternity leave, or if a particular job is completed within a relatively short period.

Conversely, temporary arrangements that are *not* based on an objective reason are viewed with some disdain in Germany. In particular, temporary arrangements that are not based on an objective reason may be entered into for a period of no more than two years; though the arrangement can be extended up to three times, the aggregate temporary period may not exceed two years.



If the parties should reach an agreement to extend a temporary agreement *after* the current agreement has already expired, or if they agree on different conditions of employment, then this is deemed to be not an extension, but the conclusion of an entirely new agreement.

"EXTENDING" A TEMPORARY ARRANGEMENT INTO A PERMANENT ARRANGEMENT

If the parties choose to extend a temporary employment agreement for an additional temporary period, German case law requires that the parties agree to this extension (i) before the then-current agreement expires, and (ii) under the same conditions of employment. If the parties should reach an agreement to extend a temporary agreement *after* the current agreement has already expired, or if they agree on different conditions of employment, then this is deemed to be not an extension, but the conclusion of an entirely new agreement. Parties are prohibited from concluding *new* temporary employment agreements under the Part-Time and Temporary Employment Act. If they should attempt to do so, then they will automatically be deemed to have concluded a permanent employment arrangement, even if this was not their intent. As discussed in this issue's article "Employers Do Not Always Have to Lose at the Game of Dominoes," it will become much more difficult for the employer to terminate the employee once a permanent employment agreement is in place.

The Federal Labor Court disagreed; it concluded that the pay raise did indeed constitute employment under different conditions, and thus, the parties had now (unintentionally) concluded a new (permanent) employment agreement.

THE FEDERAL LABOR COURT DECIDES

The issue of extending a temporary employment agreement was once again presented to the Federal Labor Court earlier this year. The facts of the August 23, 2006, decision were that the parties originally concluded a temporary agreement for one year. Two months before this agreement expired, the parties agreed to extend this for an additional year. The conditions of employment remained unchanged during this second year, except that the employee's hourly wage was increased by 50 cents. The employee subsequently argued that their arrangement did not expire at the end of the second term, as the employee now had a permanent employment agreement, because the terms of employment had changed.

The Court of Appeals sided with the employer by holding that the extension was nothing more than an extension; *i.e.*, it did not hold the pay raise to be a different condition of employment. The Federal Labor Court disagreed; it concluded that the pay raise did indeed constitute employment under different conditions, and thus, the parties had now (unintentionally) concluded a new (permanent) employment agreement. The Federal Labor Court did add, however, that conditions of employment can be amended with the proviso that such an amendment is separate from the contract extension.

IS A "SICKNESS" A "DISABILITY" WITHIN THE MEANING OF GERMANY'S NEW EQUAL TREATMENT ACT?

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Germany's newly enacted Equal Treatment Act was one of the topics discussed in our most recent edition of *German Labor and Employment News*. Since the statute is so new — it came into force on August 18, 2006 — it should come as no surprise that Germany's highest courts have not yet interpreted it. However, by way of an opinion dated July 11, 2006, the European Court of Justice (ECJ) interpreted one of the four directives that each EU member state was required to transform into its national law. This particular ECJ case involved Spain's transformation of EU Directive 2000/78/EC ("Directive Establishing a General Framework for Equal Treatment in Employment and Occupation") into its national law.

FACTS OF THE CASE BEFORE THE EUROPEAN COURT OF JUSTICE

A Spanish court referred the matter to the ECJ, as there was an ambiguity regarding the Spanish law as it related to the above-referenced directive. National courts of the EU member states may refer a particular issue to the ECJ for interpretation if the issue involves "European law," *e.g.*, the interpretation of an EU directive. In this instance, an employer had terminated an employee who had been absent from work for eight months due to an illness, and the prognosis for a return in the foreseeable future looked bleak. The nature of the illness was not disclosed by the ECJ, nor did the employer give a reason for the termination; however, the ECJ assumed the termination was due to the employee's lengthy illness.

The fact that an employer must make such an "investment" demonstrates that a disability is considered to be long-term.

INTERPRETATION OF "DISCRIMINATION" AS USED IN THE DIRECTIVE

According to Directive 2000/78/EC, an employer may not discriminate against an employee based on an employee's disability. Though "disability" is not defined in the directive, according to the ECJ, "a sickness which causes what may be a disability in the future cannot in principle be equated with a disability." Further, so as to ensure a uniform interpretation of the term "disability," the ECJ states that it refers only to "physical, psychological or mental afflictions" resulting in a limitation with respect to employment. The EU intentionally used the term "disability" rather than "illness," as it wanted to be able to distinguish between the two.

Under the directive, an employer is required to accommodate a disabled employee by setting up his workplace so as to mitigate the employee's limitations; *e.g.*, an employer must ensure that ramps are available for an employee in a

This all raises the question: Does a person's status as being "disabled" under Germany's Social Act automatically constitute a "disability" as that term is used in Directive 2000/78/EC and in Germany's Equal Treatment Act?

wheelchair. The fact that an employer must make such an "investment" demonstrates that a disability is considered to be long-term. According to the ECJ, employers should not need to worry about a long-term illness slowly evolving into a disability. This last statement, however, should be taken with a grain of salt, as the case before the ECJ concerned an employee who was merely "ill" for a long time; it did not pertain to a particular illness, nor did the ECJ disclose the nature of the illness.

"ILLNESS" IS NOT STATUTORILY PROTECTED BY THE DISCRIMINATION LEGISLATION

Article 1 of Directive 2000/78/EC sets forth an all-inclusive list of characteristics that may lead to a claim of discrimination. Neither the directive specifically nor the general prohibition on discrimination applies to "illnesses." Similar to Directive 2000/78/EC, Germany's Equal Treatment Act protects against discrimination based on race, ethnic origin, gender, religion, beliefs, *disability*, age, or sexual orientation (emphasis added). The only way that this list could include "illness" is if the German legislature were specifically to expand the Equal Treatment Act.

If a person's condition, however, is such that he could be classified as "disabled" under Germany's Social Act — but he has not gone through the registration process — it is not clear whether that person would be covered by the discrimination laws.

PEOPLE WITH ILLNESSES REGISTERED AS DISABLED

Under Germany's Social Act, disabled persons may register themselves with the local government as "disabled." However, people who are merely ill as opposed to disabled may also qualify as being disabled for the purpose of becoming registered with the local government; *i.e.*, this is not limited to persons with a disability as the ECJ defines that term. The purpose of becoming registered with the local government is to assist disabled persons to become integrated into everyday life more easily despite their disability, *e.g.*, designated parking spaces for the disabled, reduced admission prices to public events, etc. In fact, under German law, at least 5 percent of the company's workforce must be disabled if an employer has at least 20 employees. To motivate employers to satisy this requirement, the local government requires employers who fail to meet this threshold to pay an annual penalty of a few hundred euros. As is also discussed in the article "Employers Do Not Always Have to Lose at the Game of Dominoes" in this issue, disabled persons have greater protection against losing their jobs. This all raises the question: Does a person's status as being "disabled" under Germany's Social Act automatically constitute a "disability" as that term is used in Directive 2000/78/EC and in Germany's Equal Treatment Act?

If a person is already registered as "disabled" under Germany's Social Act, it would be difficult to argue that that person is not covered by the discrimination laws. If a person's condition, however, is such that he could be classified as "disabled" under Germany's Social Act but he has not gone through the registration process, it is not clear whether that person would be covered by the discrimination laws. It would seem that the provisions of the Equal Treatment Act would require that person to prove his condition of disability.

SOCIAL SELECTION PROCESS AND LEVEL OF PROTECTION AGAINST TERMINATION

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One of the basic tenets of German employment law is that an employer must consider an employee's years of service, age, number of dependents living at home, and any disability before terminating an employee for operational reasons. An employer's failure to consider these "social" factors properly will jeopardize the validity of the terminations. (For a more detailed discussion regarding the termination of employees, see the article in this issue "Employers Do Not Always Have to Lose at the Game of Dominoes.")

Even the German legislature saw the light, however, and thought it not advisable to force employers to terminate highly skilled employees just because these employees may be younger, not have many years of experience, etc.

On the other hand, some employees essentially enjoy absolute protection against termination for operational reasons.

SOCIAL SELECTION PROCESS

If another position with the company is not available for an employee who is to be terminated for operational reasons, the employer must commence with the social selection process. This requires the employer to weigh "comparable" employees' above-mentioned social factors within their respective departments. The stronger the social factors — *i.e.*, if the employer is older, has dependent children, has many years of service, or is disabled — then this employee has greater job protection.

Even the German legislature saw the light, however, and thought it not advisable to force employers to terminate highly skilled employees just because these employees may be younger, not have many years of experience, etc. As a result, an employer may be able to exclude crucial employees (*i.e.*, those with special skills or know-how) from the social selection process, and thereby not be required to terminate them, even though their social factors would otherwise warrant termination.

TERMINATION PROTECTION ACT: HOW MUCH PROTECTION DOES AN EMPLOYEE REALLY HAVE?

The requirement to engage in the social selection process is set forth in Germany's Termination Protection Act. However, this statute does not apply to all employees; for example, it does not apply to those who are still subject to a probationary period. Under German law, these employees enjoy the least amount of protection against termination, meaning the employer must terminate them first if the terminations are for operational reasons.

Even if the employer needs to provide training or schooling to the "nonterminable" works council member, that employee still has priority over the other employees in terms of not being terminated.

On the other hand, some employees essentially enjoy absolute protection against termination for operational reasons. For example, under the Termination Protection Act, works council members are generally not terminable. In fact, according to a six-year-old opinion of the Federal Labor Court, if an employer seeks to terminate a works council member (*e.g.*, because the employer is closing the entire division in which the works council member is employed), the employer must terminate an individual from a different division in order to make a position available for the works council member, meaning the "terminable" employee is essentially a surrogate termination. Even if the employer needs to provide training or schooling to the "nonterminable" works council member, that employee still has priority over the other employees in terms of not being terminated.

Also, it is not uncommon to find in a collective bargaining agreement a provision setting forth that employees at least 55 years old and with at least 10 years of service may generally not be terminated. In this case, an employer would also need to find a "terminable" employee to terminate before dismissing the "nonterminable" employee. This would be the case regardless of whether the employee's "nonterminable" status was the result of a collective bargaining agreement or an individual employment agreement. The one exception to this statement is if the parties included the protection-against-termination clause into the employment agreement solely with the intent of circumventing Germany's employment laws in bad faith; *e.g.*, they included the provision so as not to subject that employee to the social selection process solely for personal reasons.

A WORD OF CAUTION WHEN PROMOTING AN EMPLOYEE TO MANAGING DIRECTOR OF YOUR COMPANY

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German employment law distinguishes between (i) an employee, and (ii) the managing director (*Geschäftsführer*) of a company with limited liability (*Gesellschaft mit beschränkter Haftung*, commonly abbreviated "GmbH"). A managing director is essentially the CEO of the company; he is not, however, considered to be an "employee" of the company for legal purposes. While employees in Germany are generally protected against termination by various statutory "pro-employee" provisions — at least from an American perspective — these same provisions do not apply to managing directors.

Since this same level of protection against termination is not afforded to managing directors, managing directors will typically seek the inclusion of a relatively long termination notice period in their managing director agreements (*e.g.*, six months or even one year), or possibly ask for a provision that would prohibit the termination of the managing director for a certain time period (*e.g.*, the first two years of the managing director agreement).

Though distinguishing between employees and managing directors may initially appear simple enough, things become a bit more complicated when the shareholders of the company — they are responsible for appointing and removing the managing director — decide to remove a

The issue is: Was the former employment relationship only *suspended* during the person's stint as managing director, or was it automatically *severed* upon the employee's promotion to managing director?

The most salient point when this issue arises is the parties' intent when they originally concluded the managing director agreement. . . . The general rule of thumb is that the parties intended to terminate the employment relationship — as opposed to only suspending it — when they entered into the managing director agreement.

managing director who had previously been an employee of the company. Disputes often arise as to whether such an individual automatically reverts back to his "employee" status once he is removed as managing director despite the company's wishes that he be removed from the company entirely. The issue is: Was the former employment relationship only *suspended* during the person's stint as managing director, or was it automatically *severed* upon the employee's promotion to managing director? If it is the former, the (now) ex-managing director is then once again an employee of the company. If it is the latter, the company severed all ties with the (now) ex-managing director when it removed him as managing director.

RECENT DECISION OF THE FEDERAL LABOR COURT

On June 14, 2006, the Federal Labor Court once again grappled with this issue. In that case, an individual who had served as managing director of a German company filed a wrongful-dismissal action after his managing director agreement had been terminated. He had been promoted to managing director after he had been an employee of the company for 15 years. His managing director agreement was initially valid for a period of five years. Pursuant to this agreement, the company could not terminate him, except for cause, during this five-year period. The parties subsequently extended this agreement for consecutive three-year periods, though either party could terminate the agreement by observing at least a 12-month termination notice period prior to the expiration of any such three-year term. The company eventually terminated this agreement, causing the managing director to argue that the termination of his managing director agreement caused him to automatically revert back to his former status as an employee. Accordingly, he argued, the company could not terminate him as an employee without observing the various statutory provisions that protect employees (for a discussion of these provisions, see in this issue the article "Employers Do Not Always Have to Lose at the Game of Dominoes"). The managing director's argument did not meet with success.

A FEW GROUND RULES

The most salient point when this issue arises is the parties' intent when they originally concluded the managing director agreement. Did they wish only to suspend the employment relationship, or did they wish to sever it? The Federal Labor Court assists in interpreting the parties' intentions by setting forth a few ground rules:

- The general rule of thumb is that the parties intended to terminate the employment relationship — as opposed to only suspending it — when they entered into the managing director agreement.

- Unless the parties agree otherwise, the employee must accept that he will lose his "employee" status when concluding a managing director agreement, since their relationship is now based on a new contractual relationship, causing the former contractual relationship (the employment relationship) to become moot.

- If there are specific indications that the parties did not intend to sever the employment relationship, then it will only be suspended. For example, if an individual is to serve as managing director for only a brief period, and the parties do not amend that individual's employment agreement, then it is fair to assume that the parties' intent was only to suspend the employment relationship.

WORD OF CAUTION!

The Federal Labor Court has always explicitly left open the issue of whether parties must *specifically* set forth in writing that they are ending the employment relationship

Regardless, until the Federal Labor Court decides such a case, employers are well advised to continue to terminate the employment relationship expressly when promoting one of its employees to managing director.

upon entering into the managing director agreement. Since May 1, 2000, however, Germany's Civil Code has included a provision that a party can end an employment relationship only in writing. The Federal Labor Court opinions rendered to date always involved cases in which the managing director agreement was concluded *prior* to May 1, 2000.

How will the Federal Labor Court decide a case in which the parties concluded a managing director agreement after May 1, 2000? Legal commentators' opinions on this issue run the gamut. Regardless, until the Federal Labor Court decides such a case, employers are well advised to continue to terminate the employment relationship expressly when promoting an employee to managing director.

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