EDITORIAL

After undergoing the legislative process, the GmbH reform (generally referred to as the “MoMiG”), on which we touched in our last issue, was passed by the German Bundestag on June 26, 2008. For this reason, we are again highlighting a range of topics that will be relevant to the M&A Practice.

Since the case law of the last several years has increasingly called into question the participation of German limited liability companies in cash-pooling agreements, the MoMiG facilitates the use of this widespread instrument of liquidity management within corporate groups and repeals in large part the limitations established by case law regarding raising and maintaining share capital.

Furthermore, the MoMiG for the first time permits the bona fide sale of the shares of a German limited liability company by nonowners that are identified in the company’s shareholder list registered with the commercial register. Although this new instrument does not serve any compelling need of the M&A Practice (it is regarded merely as “nice to have”), there will be interesting effects on transactional practice. How far these effects go, however, must be seen in practice.

Our contribution on change-of-control clauses in joint-venture companies highlights a case from our corporate practice. In many cases, change-of-control clauses that are too narrowly drafted impede corporate group restructurings at the level of the joint-venture parent. Our article demonstrates how such restructurings can nonetheless be implemented in many cases, maintaining the existing control structures to a great extent and thus frequently avoiding the need for the consent of the joint-venture partner.
A legislative bill introduced by the Federal Ministry of Justice at the beginning of this year is intended to reform the German international corporate law, i.e., the law that applies to substantive facts in cases with an international dimension. The government’s approach expands the internationalization of corporate law that has in part taken effect within the framework of the European Union. According to the bill, a foreign company will be able to transfer its seat to Germany without losing its corporate form or identity; the same applies for a German company transferring its corporate seat outside the country. In addition, beyond the cross-border mergers of corporations that are already possible within the EU, future cross-border corporate restructurings of all types may include German companies. In certain areas, however, there is still significant need for greater specification and modification of the rules set out in the bill, which is not surprising at this early stage of the legislative process.

The Jones Day German M&A and Private Equity Team

**POOLING PERMITTED: MOMIG FACILITATES CASH-POOLING AGREEMENTS FOR GERMAN GMBHs**

By Stefanie Stöhr

Cash-pooling agreements, e.g., agreements regarding liquidity reconciliation between companies within a corporate group, have numerous advantages for the participating companies: they make it possible to optimize borrowings in the entire corporate group, ensure that all members of the corporate group are continually supplied with liquidity, provide for more transparency, and allow for increased control by the corporate group’s management. From a legal perspective, the cash pool constitutes a current account relationship between the individual subsidiaries on the one hand and the corporate parent as central financing entity on the other—any cash surplus at the subsidiaries is deducted from the company’s account on a daily basis and flows to the corporate parent in the form of a loan.

The compatibility of cash-pooling agreements involving German Gmbh with Section 30, paragraph 1, of the German Limited Liability Company Law, e.g., the prohibition on repayment of the funds required to maintain the company’s paid-in capital to the company’s shareholders, was questioned by the “November Decision” of Germany’s Federal Supreme Civil Court on November 24, 2003. In this decision, the court deviated from the prevailing “balance-sheet view”: according to this view, capital maintenance restrictions are violated only if the payment of the loan amount by the German GmbH is not offset by an adequate
claim to repayment vis-à-vis the shareholder (e.g., there is not merely a neutral accounting change on the asset side on the balance sheet). In the November Decision, in contrast, the Federal Supreme Civil Court held that lending to the shareholder diminishes the GmbH’s net assets and can therefore violate the maintenance of capital rules, irrespective of the value of the loan repayment claim. The exchange of liquid assets for deferred contractual repayment claims worsens the creditor’s prospects of having its claims satisfied, according to the Federal Court of Justice. The creation of cash-pooling systems in which German GmbHs participated therefore became possible only with significant limitations.

The MoMiG now signals a return to the balance-sheet view. The future version of Section 30, paragraph 1, sentence 2, of the German Limited Liability Company Law provides that the maintenance of capital rules does not apply “in the case of goods or services that are covered by full value repayment or consideration vis-à-vis the shareholder.”

It is unclear, however, whether this rule applies in the case of repayment claims that are initially of value but later lose this status, e.g., if the shareholder later becomes insolvent. According to the legislative background of the MoMiG, later unforeseen negative effects on the repayment claim against the shareholder as well as balance-sheet devaluation should not retrospectively lead to qualification as a prohibited payment. However, under such circumstances, the managing director’s duty of care may have been breached if he permitted the claim to remain outstanding even though demand for payment could have been made. As a result, a significant liability risk remains for the managing director if he misjudges the liquidity situation of the parent company or if the cash-pooling agreement of the GmbH does not permit termination under these circumstances.

The MoMiG also clarifies the issue of cash-pooling arrangements and concurrent contributions due to increases of share capital. If the capital of a GmbH participating in a cash pool is increased, the company typically has liabilities...
to its parent that arose in connection with the cash pool.

If a cash capital increase is agreed upon, the parent pays the capital contribution into a newly established account of its subsidiary. The potential issue arises when, directly after the registration of the capital increase, the contribution is transferred to the subsidiary’s account that is involved in the cash pool and then booked to the main account of the parent on that same day in connection with the cash pool. These types of “back and forth” payments had previously been regarded as a disguised contribution in kind by the Federal Court of Justice (and in consequence are void), since the subsidiary did not receive the cash amount, only a proportionate release from its long-standing loan obligations to the parent. In a landmark decision in 2006, the Federal Supreme Civil Court affirmed that these principles also apply to a company that participates in a cash pool without recognizing a “privilege” for this type of group company financing arrangements.

According to the MoMiG, a disguised contribution in kind, to the extent it has value, is sufficient to fulfill the obligation to contribute to the capital of a company. The shareholder has to (re-)contribute only that portion of the contribution that was not of full value (liability for the difference only).

Further, if the transfer takes place after registration of the capital increase based on the subsidiary’s participation in the cash pool for the first time (and thus there are no existing loan liabilities vis-à-vis the parent company), contrary to past practice, this is now interpreted as a permissible return of the contribution. According to the MoMiG, an agreement regarding payment to the shareholder reached before the contribution is made that constitutes the economic equivalent of the return of the contribution does not require the shareholder to make the contribution once again if it is covered by a corresponding claim to return such funds that is of full value.

As a consequence, in the area of raising and maintaining capital, a balance-sheet approach is being reinstated by the MoMiG. Cash-pooling systems will therefore be easier to implement in the future, although a prerequisite remains that any claims for repayment vis-à-vis the parent company are of full value.

**BONA FIDE TRANSFERS OF GMBH SHARES UNDER THE MOMIG**

By Marc O. Peisert

In the context of the transfer of interests in a German limited liability company, a bona fide purchase of the shares from a seller owning such interests was not possible. In contrast to the purchase of real property or movable goods, the purchaser’s good-faith belief in the ownership of the would-be seller was not protected. The purchaser therefore could not obtain ownership rights over the shares. Although the purchaser in an M&A transaction typically receives broad warranties that at least cover financial damages, these seldom compensate for the full commercial damages of a failed transaction.

The MoMiG now provides for a bona fide purchase of shares in a GmbH; this means that the effective acquisition of shares from a nonowner will be possible in the future. The good faith required to make such a bona fide purchase will now be based on the shareholder information contained in the shareholder list that has to be submitted to the commercial register. This shareholder list had previously served as an information source for the shareholdings in the GmbH, but due to the lax provisions on submitting such a document, it was inadequate as a basis for a finding of good faith. In order to increase the reliability of the shareholder list, the MoMiG has now tightened the provisions requiring its submission. Notaries that are involved in transactions made by notarial deed in which the shareholders change (such as the transfer of shares via notarial deed) now have the obligation to submit the shareholder list to the commercial register. In addition, the liability of the managing directors, who must submit the shareholder list in all other cases, is exposed in the case of nonsubmittal.
Despite these safeguarding measures, the reliability of the shareholder list is limited. The accuracy of the shareholdings according to the shareholder list is not examined by the commercial register. Also, if the transfer is subject to a condition precedent (such as approval by the competition authorities), the notary recording the conditional transfer is not obligated to keep informed about whether the condition has been satisfied, nor to submit the shareholder list at that time; this continues to be the obligation of the managing director of the company. Further, the legislature decided against requiring notarial certification of the signature of the managing director submitting the application; therefore, it is possible that falsified shareholder lists will be submitted. Due to these loopholes, the legislature decided that the list should not have a full and immediate impact on the finding of good faith and instead introduced a step-by-step system.

**TIME LIMITATIONS**

The intensity of the protections provided by the MoMiG is determined by how long the shareholder list was inaccurate at the time of the transfer. The shareholder list can be inaccurate for two reasons: it can be inaccurate at the outset, such as when the submitted list is inconsistent with the actual shareholdings of the company, or it can become inaccurate later, if the shareholdings change without submission of a new list.

If the list was inaccurate for a period of more than three years at the time of transfer, the purchaser is required only to demonstrate good faith. “Good faith” means that the purchaser may not have had knowledge of the inaccuracy of the shareholder list or was not grossly negligent in lacking such knowledge. If the shareholder list was inaccurate for a period of less than three years, in addition to the good faith of the purchaser, the inaccuracy of the list must be able to be imputed to the true owner of the shares. This is the case, for instance, when the true owner affirms the inaccuracy of the shareholder list or, despite knowledge to the contrary, does not object to the inaccuracy of the shareholder list.

Independent of the length of time that the shareholder list is inaccurate, the purchaser cannot obtain the shares from the person not authorized to sell them if an objection as to the inaccuracy of the list is entered with the commercial register. Such entry is possible either with the consent of
the person authorized to sell the shares according to the shareholder list or on the basis of an interim judicial order. If an objection is incorrectly entered, it remains possible to purchase the shares from the actual owner set forth in the shareholder list. However, in such a case, due to the fact that no bona fide transfer will be possible, the purported ownership should be verified with the utmost diligence.

**LIMITS ON BONA FIDE TRANSFERS**

The scope of the good-faith protection is limited. First, good faith applies only in the case of shares that actually exist; there is no good-faith creation of a nonexistent share. Further, good-faith protection does not extend to existing encumbrances such as pledges or easements; a bona fide purchase extinguishing prior liens as under the law of real property based on the land register is therefore not possible. Good faith is also not sufficient to override provisions restricting transferability that may be found in the company’s articles of association—in this context, the consent of the shareholder remains necessary.

A further disadvantage for the purchaser in the future is in the case of transfers subject to a condition precedent. Here, subsequent disposals of the shares vis-à-vis the first purchaser had been invalid (Section 161, paragraph 1, of the German Civil Code). According to Section 161, paragraph 3, of the German Civil Code, the provisions relating to good faith will now apply so that in the case of a subsequent transfer during the time that the condition precedent has not yet been satisfied, the second good-faith purchaser can obtain ownership of the shares. A corresponding protective mechanism, as under real property law, in the form of priority notice in the commercial register to safeguard the first purchaser’s claim has not been created by the legislature. Alone, the registration of an objection by mutual consent could be of assistance here; however, the shareholder list is not inaccurate until the condition is satisfied so that the objection would, in fact, be unfounded in substance. It remains to be seen how this gap is closed in practice; it is possible that the legislature will propose further amendments.

**EFFECTS ON DUE DILIGENCE AND CONTRACTUAL DOCUMENTATION**

For the M&A practitioner, the question arises as to the practical effects of the new rules in carrying out M&A transactions. In the context of M&A due diligence, one is faced with a dilemma: on the one hand, the length of time that the list is inaccurate determines the level of protection afforded to the purchaser, so that in theory, a positive determination of the point in time at which the shareholder list became inaccurate is necessary. At the same time, however, the positive determination of the inaccuracy would destroy good faith. Too much knowledge can therefore be harmful. This means, in practice, that if a shareholder list is more than three years old, transfers of shares prior to that time can be disregarded, although it will still be necessary to ascertain whether there have been any subsequent transfers of shares.

A related practical question is whether failing to conduct any due diligence whatsoever is to be considered grossly negligent per se, with the consequence that no bona fide transfer is possible. The question has to be answered in the negative, since the purpose of the good-faith transfer would otherwise be defeated—an innocent purchaser is exactly the one who should be protected here. However, due to the loopholes discussed previously, there is a danger that the transfer would fail on the grounds identified above, in which the protections of good faith do not apply (nonexisting shares, restrictions on transferability). To this extent, the liability of the management of the purchaser is still possible, due to the lack or insufficiency of due diligence.

While the new rules apply to companies that are incorporated after the effective date of the new law, the law provides for a transitional period for existing companies so that the full protections of good faith apply, at the earliest, three years after the reform takes effect. In order to avoid complications, companies with interests in GmbHs should utilize this transitional period to ensure that they are registered as shareholders in the respective shareholder list; in addition, in the subsequent period, regular checks of the shareholder list should be made for compliance reasons.

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CHANGE-OF-CONTROL CLAUSES IN JOINT-VENTURE COMPANIES: LEGAL PITFALL IN THE CONTEXT OF GROUP RESTRUCTURING

By Dr. Martin Kock

Whether for tax reasons prior to the end of the fiscal year or to reorganize the corporate group in preparation for acquisitions or divestitures, corporate group restructurings generally take place under time pressure. Presumably they are under control, since the transactions take place “in house.” Caution is warranted, however, when—as is often the case—the corporate group holds interests in joint-venture companies.

Since the “fit” with the joint-venture partner is particularly important in the joint-venture context—unlike in a purely financial participation—each of the partners has an interest in protecting the ownership structures of the joint venture from unwanted changes. For this reason, change-of-control clauses are often used. In a first step, these clauses provide that the sale of shares in the joint-venture entity must be approved by the joint-venture partner. In addition, the nonselling shareholder is often granted preemptive rights; on the other hand, the nonselling shareholder can also be obligated to purchase the shares to be sold in the event he refuses to consent to the sale to third parties. In a second step, more complex clauses also cover the direct or indirect change in the ownership structure of the group entity holding the joint-venture shares (the “JV parent”). In this case, the corporate group entity can be obligated to sell its shares to its partners. Preemptive rights with respect to the shares of the JV parent are, in contrast, more difficult to implement and are typically not desired by the parties.

Such change-of-control clauses can be a problem in the context of a corporate group restructuring. If the JV parent is transferred within the group, a change in ownership formally occurs on the parent level, so the question arises whether the relevant change-of-control provision is triggered. It is highly advisable to address this question when forming the joint venture by providing for exceptions for transactions within the corporate group at both levels.

If the joint-venture agreement does not include such an exception, an attempt should generally be made to resolve the issue with the other joint-venture partner. Experience shows, however, that joint ventures generally have a sensitive equilibrium of conflicting partner interests. Therefore, every accommodation that goes beyond the contractual
obligations typically has to be “paid for” by concessions from the partner requesting such accommodation.

Alternatively, one could also take the position that no change of control within the meaning of the clause has occurred. The whole purpose of change-of-control clauses supports this argument. The clause is intended to prevent third parties from influencing the joint venture; if the shareholding remains within the corporate group, there is no new partner from a corporate perspective. However, maintaining such a position may lead to discussion, even litigation. Therefore, measures should be taken which support the argument that there has been no change in control on a formal level, such as concluding specific control and control-prevention agreements as set out below.

Typically, change-of-control clauses encompass the acquisition or change of control over the JV parent in the corporate group. “Control” may be defined directly by reference to the corporate-law definition of “dependence” in the German Stock Corporation Act, or the definition may be fixed in the joint-venture agreement itself. Such definitions usually make clear that from a corporate group perspective, indirect control of the JV parent is exercised by the “higher level” companies, all the way up to the ultimate corporate parent. Therefore, if the JV parent is transferred within the group, it can by way of precaution conclude a so-called control-prevention agreement with its new parent. Such an agreement suspends corporate control and decisional authority and therefore prevents the new parent from obtaining control over the JV parent. However, the control chain remains interrupted by this type of agreement, as the JV parent is no longer controlled by anyone. Therefore, at the same time, a control agreement must be concluded with the JV parent and one of the companies in the old chain of control; this is most easily accomplished by concluding the agreement directly with the ultimate parent company. Although the entity that was formerly a higher-level company to the JV parent (and, in turn, even higher-level companies) therefore loses its control due to the transaction, a control change does not take place, since a change-of-control clause is typically worded to cover the acquisition of control rather than its loss or change. Through the control agreement, control is still exercised along the old control chain. At that level, direct control is merely substituted for indirect control; however, this change in the control structure is generally not covered by a change-of-control clause.

One must realize that even this construction does not entirely remove the risk of litigation. However, it does enable the joint-venture partner to base its arguments against a change-of-control event on the rationale of the clause, as well as on the wording. This will, in any case, improve the bargaining position. The exact wording of the change-of-control clause is decisive—the more clearly the clause refers to the statutory definition in the German Stock Corporation Act or the control of the ultimate corporate parent, the safer it will be to implement the corporate restructuring without the consent of the joint-venture partner.

The internationalization of German corporate law is moving forward. In addition to the traditional business entities of German corporate law, further corporate forms are available for companies to use today. These include forms available under the law of the European Union, such as the European Association and the Societas Europaea, and those available under the laws of the other EU Member States, such as the limited company under English law. Since April 2007, German companies have had the choice of merging with companies that are incorporated pursuant to the laws of other Member States. Recently, the Federal Ministry of Justice presented its first draft bill on the Law Applicable to Companies, Associations, and Legal Persons (hereinafter, the “Draft Bill”), which represents a further step in this direction. Thus, in the future it will be possible to operate foreign subsidiaries using the legal form of the German limited liability company.

**BACKGROUND**

Under traditional principles of German law, a company can be domiciled only in the legal system pursuant to which it
was formed. Should a German limited liability company be transferred to a foreign country, the resolution of the shareholders to this effect would be construed as a resolution to liquidate the company. Conversely, German corporate law would apply to foreign companies that transfer their headquarters to Germany. If an English limited company were moved to Germany, German courts would then alternatively apply the law of partnerships due to the apparent non-compliance with German limited liability law—with serious consequences for the liability of the company’s shareholders and managers.

In various decisions handed down between 2003 and 2005, the European Court of Justice clarified that in the case of relocation of foreign companies, such companies enjoy the protections of the European freedom of establishment and consequently continue to be subject to the corporate law under which they were incorporated. Since then, a number of companies became domiciled in Germany while being organized in the form of an English limited company.

However, in the case of the relocation of a German company to a foreign country, the traditional legal principles remained applicable. A German limited liability company, therefore, still has to be domiciled within Germany.

**APPLICABLE CORPORATE LAW**

The Draft Bill now provides that companies, associations, and legal persons under civil law are subject to the law of the state in which they are registered in a public register. With respect to companies from other European countries, the principles set forth by the European Court of Justice will therefore be incorporated into German law. However, the proposed rule goes beyond this: on the one hand, the rule is not limited to companies from other countries in Europe such that in the future, companies that are domiciled in countries outside the European Economic Area can transfer their seats to Germany. This is the case, as commentators accurately point out, “for refreshment stands in Bochum Wattenscheid just as well as for GAZPROM Germania domiciled in Berlin as the subsidiary of a foreign company. Both may in future be operated as companies under Russian law.”

On the other hand, the rule will also permit German companies to move out of Germany without resulting in their
liquidation. Henceforth it will be possible for a German company to uniformly organize its foreign subsidiaries in the form of a German limited liability company. Parallel changes to the German limited liability company law are planned in the course of the reform of this area of law, which is currently underway.

However, the ongoing applicability of the law of the state in which the company was incorporated is limited to corporate matters. In particular, in the case of insolvency, the law of the company’s administrative seat will continue to apply (under certain circumstances). The same is the case for tortious conduct of the company or its corporate bodies.

- **CHANGE-OF-CORPORATE-FORM CASES**
  The Draft Bill further provides that the requirements, process, and effects of a restructuring via merger, split-off, asset transfer, or change in corporate form for each of the entities involved in such measures are subject to the laws of the states in which they are registered in a public register. For example, in accordance with this rule, in the case of the merger of a Dutch B.V. into a German limited liability company, the B.V. would be subject to the Dutch merger law, while the German limited liability company would be subject to the relevant provisions of the German Reorganization of Companies Act.

This rule will fundamentally make legal practice easier, since the theoretical argument regarding which law applies to corporate reorganizations will become moot. Initially, however, the direct effect of the new rule will be limited, since the new rule only represents a standard to apply when determining which substantive law is applicable in the event of the conflict of two opposing rules. Procedural rules, including rules regarding the dovetailing of the two legal systems that are to be applied, are not included in the Draft Bill. If one of the applicable laws does not address the prerequisites to and the process for cross-border reorganizations, the legal uncertainty will remain. An example of this is in Sections 122a et seq. of the German Reorganization of Companies Act, which addresses the process of cross-border mergers of corporations. Types of reorganizations other than the merger of corporations are still not addressed, however; in particular, there are no rules for partnerships. This will not be changed by implementation of the Draft Bill.

- **CROSS-BORDER CHANGE IN CORPORATE FORM**
  A further fundamental reform in the Draft Bill is the ability of a company to be subject to the law of another country while preserving its own identity. This can be deemed a cross-border change in corporate form. For example, according to a press release of the Federal Ministry of Justice, it will become possible for a German limited liability company to transfer its corporate seat to France by registering with the relevant commercial register in France as a S.à.r.l. and deleting its registration in the German commercial register. The Ministry, however, has overlooked the fact that according to the text of the Draft Bill, “the previous as well as the new law to be applied allows a change in corporate form without liquidation and new incorporation.” According to prevailing opinion in German jurisprudence, this is not an option for a German company. For this reason, the Draft Bill needs to provide for additional changes to the law currently in effect in order to fulfill the purpose expressed in the Ministry’s press release. The foundation for a cross-border change in corporate form was laid in the current text of the Draft Bill, but such a change in corporate form has not been achieved.
CONCLUSION

The Draft Bill represents a further step in the internationalization of German corporate law following the implementation of the merger directive. The link to the site of the registration in a public register increases legal certainty in international commercial transactions. Beyond this, however, the Draft Bill will not result in any changes in practice, since for the most part, only questions of the law to be applied have been settled and the Draft Bill does not contain any procedural solutions addressing cross-border issues. It therefore remains to be seen whether and how unaddressed legal issues will be handled in further legislative steps. Since German international conflict-of-law rules apply only in Germany, it is certainly desirable to have uniformity within Europe of the rules included in the Draft Bill.

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