



INVESTING IN GERMANY

USEFUL INFORMATION FOR U.S. PARENT COMPANIES: CONCERNS AND ISSUES OF THE LOCAL GERMAN MANAGEMENT

Jossip Hesse and Christiane Micha Buse Heberer Fromm

If a strategic or financial investor intends to acquire an existing business in Germany, there are generally two main ways of deal structuring: asset deal or share deal. While a share deal will in most cases be the appropriate one, numerous questions about the particular deal structure and its details remain. Should the shares be acquired directly through an existing legal entity owned by the investor with its seat in the U.S. or should the acquiring entity have its seat in another jurisdiction? Is it advisable to establish a special purpose vehicle as the directly acquiring entity or as something like a buffer with its seat and place of management in Germany, in another European Union member state or somewhere else? How can a debt push-down for German tax purposes be realized in case of a debt-financed acquisition? In larger deals, in particular, it is evident that the structuring and the future investment structure are quite often tax-driven. In smaller deals, tax and accounting aspects are not always taken into sufficient consideration. Regardless of the size of the deal, it may make sense to ask whether the structure of the executed transaction as well as the established group struc-

ture fit the group-wide operational business, reporting structures, and intra-group hierarchies and supports, e.g. the German local management doing its job successfully and in line with German law. Thus, the challenge is to develop and execute deal structures and subsequently establish group structures which take into account the interface between organizational, operational, financial (accounting), tax and legal issues and approaches without trying to square the circle.

In the following we would like to draw your attention to some selected concerns and issues managing directors of a U.S. investor's subsidiary in Germany may encounter, using as an example a German limited liability company (*Gesellschaft mit beschränkter Haftung*; short form: *GmbH*).

INSTRUCTIONS OF A U.S. PARENT COMPANY TO THE MANAGING DIRECTORS OF THE GERMAN GMBH

A GmbH is generally represented by one or more managing directors (MDs) who manage the company's affairs jointly. The responsibility of an MD relates only to matters within the field of activities defined as the company's purpose in its statutes. Certain

specific matters of major importance are reserved for decision by the shareholders. Either through the statutes or by way of a resolution, the shareholders may extend or restrict the scope of an MD's responsibility. Shareholders can assign a lot of responsibility matters that are generally reserved for decision by the shareholders to the MDs. But they can also subject certain types of transactions and measures which as a rule belong to the MD's sphere of responsibility to the shareholder's prior consent. Within certain limitations shareholders of a GmbH – contrary to those of a German stock corporation – are entitled to instruct the MDs to execute a specific measure for and on behalf of the GmbH. Based on a formal, valid shareholders' resolution which does not violate the applicable law, such an instruction can exculpate the MD and, therefore, limit his personal responsibility in case of negative consequences of the measure which may come into effect at a later stage at the GmbH. In practice, the hierarchies of the reporting and instruction structure (matrix) within a group of companies quite often do not comply with the corporate group structure. Example: A division head formally em-

ployed with a U.S. sister company of the German GmbH instructs the German MD against the MD's personal opinion. If the MD follows the instruction, it can result in the MD's personal liability for (future) damage if e.g. the measure leads to an economic disadvantage from the GmbH's perspective, even if it was for the group's benefit or that of a direct or indirect shareholder. Thus, a GmbH's MD generally should not follow instructions issued from a corporate group member that is not a formal direct shareholder of the GmbH. To solve the potential organizational and legal conflict of interests, a further legal framework is required.

THE MD'S GENERAL AND SPECIAL OBLIGATIONS

Under the statutory joint management concept of a German GmbH, management decisions require the consent of all MDs. The concept can be modified by the shareholders within the GmbH's statutes or by way of shareholder resolution. The shareholders might assign specific fields of responsibility – e.g. administration, accounting, finance or production – to one or more MDs. However, no MD can be completely released from the joint overall responsibility for the GmbH's well-being. Thus, any managing director in charge of a special area of responsibility must report to the other managing directors about relevant matters that arise in his particular area. Relevant matters are generally such matters which have an overall effect on the GmbH. Correspondingly, any MD may concern himself with matters in an area of responsibility assigned to another MD if he believes the overall well-being of the company may be affected by decisions taken with respect to those matters.

In his capacity as the representative who is generally overall responsible for the GmbH, an MD must apply the diligence of an orderly businessman. The general obligation of diligent management particularly includes using one's best efforts to promote the GmbH's purpose, as well as complying with, and ensuring the GmbH's compliance with, all applicable statutory and other legal obligations and requirements. This includes the requirement that the GmbH keeps proper books of account and records. The MD must not make or accept improper payments and must not compete with the GmbH. Furthermore, he is not allowed to disclose trade or business secrets or other confidential information belonging to the company. In due diligence procedures, the MD has to avoid any risk which could put the existence of the company at risk and to employ the due diligence appropriate to the size and complexity of the structure as well as the activity of the GmbH.

Special obligations and liabilities are imposed upon MDs with respect to ensuring the contribution and preservation of the GmbH's share capital. In particular, the acceptance or issuance of shareholder loans, the integration of a German GmbH into a group-wide, cross-border cash-pooling system, as well as payments based on cross-border contribution or effort allocation agreements which can easily interfere with the general diligence of an orderly businessman and/or with the specific statutory regulations have to be considered by the German management from the German GmbH's perspective. Ignoring this may lead to severe personal risks for the MD in charge. Consequently, the MD's potential critical attitude towards respective agreements issued by the U.S. shareholder should not be understood as defiance on the part of the German MD's but rather as an indication of his professional competence. This is not to say that a German GmbH cannot be integrated into a cross-border cash-pooling agreement or grant loans to its direct or indirect shareholder or affiliates. However, the relevant German legal requirements have to be considered at an early stage, and for instance, specific information rights of the GmbH regarding the financial situation of the cash-pool leader or shareholder as well as a specific right of termination of the respective agreement may have to be agreed.

In case of a financial crisis of the GmbH the statutory subordination of loans issued by a shareholder holding at least 10% of the subscribed share capital regularly becomes an important issue. If an MD causes the GmbH to pay back the loan, he can be personally liable. Furthermore, there is a severe risk that a statutory subordination or an explicitly stipulated subordination of a loan may lead to taxable income at the level of the GmbH, unless the subordination clause meets specific requirements defined by the German tax courts.

POST-MERGER INTEGRATION

Subsequent to the acquisition of a German legal entity or group, the new shareholder intends to integrate the "German business" into the shareholder's ERP and/or bookkeeping system. What may be reasonable from an organizational perspective and could support a consistent and efficient intra-group financial reporting can interfere with both German general accounting standards and significant tax compliance regulation. In particular, the transfer of the physical bookkeeping and its data storage (or parts of it) to the U.S. must not be executed without the prior specific approval of the German tax authority. Furthermore, one should keep in mind that a bookkeeping in line with U.S. GAAP does not render unnecessary the on-

going bookkeeping in line with German GAAP and applicable German tax law. Supposedly uncritical post-merger integration measures can not only lead to problems for the German MDs but also directly to severe (tax) risk exposures at the level of the acquiring legal entity as well as at the level of the target including its subsidiaries. For instance, a formal improper bookkeeping system can be harmful for the validity of a fiscal unity that has been established in the course of the acquisition in order to realize a kind of debt push down for German tax purposes.

RECOMMENDATION

The scenarios discussed above are far from complete, but are important examples of which U.S. parent companies and their decision makers as well as the MDs of a German GmbH should be aware. The awareness of the potential conflicts of interests and responsibilities, partially driven by different legal systems, may support appropriate communication between the persons in charge at the level of the ultimate and each intermediate shareholder, affiliated companies and the management of a German subsidiary. Prior to the development and rollout of reporting and instruction lines and matrixes, the initiation of relevant cross-border payments and capital measures and/or conclusion of cross-border financing and service agreements, we strongly recommend cross-checking the operational and organizational intentions from a legal and tax point of view in order to avoid subsequent exhausting discussions with persons in charge as well as authorities such as the German tax authority.



Jossip Hesse is qualified as a lawyer as well as a tax advisor (Germany) and Partner with Buse Heberer Fromm in Hamburg and Essen. He is Head of the Practice Groups Corporate/M&A and Tax Law. Jossip can be reached at hesse@buse.de.



Christiane Micha is a lawyer qualified in commercial and corporate law as well as tax law, and Senior Associate with Buse Heberer Fromm in Frankfurt am Main and Essen. She is a member of the Practice Group Corporate/M&A and the Practice Group Real Estate Law. Christiane can be reached at micha@buse.de.