Martin Schulz
Oliver Wasmeier

The Law of Business Organizations

A Concise Overview of German Corporate Law

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Preface

This book provides a concise overview of the relevant legal framework governing German business organizations. Thus, our book is neither meant to be fully comprehensive in scope, nor can it substitute the advice and guidance of qualified attorneys and tax advisors in individual cases. Rather, this book is intended to provide the reader with a basic introduction into some key aspects of German business law in general, and of German corporate law in particular. Our goal is to help business practitioners and international students to familiarize themselves with the general framework and the characteristic features of German corporate law.

The first chapter provides an introduction into the economic background and general aspects of conducting business in Germany. To this purpose we present some characteristic features of the German legal system, outline the legal framework, and give an overview of typical forms of business organizations. The next two chapters focus, in particular, on the German stock corporation (*Aktiengesellschaft, AG*) and the German limited liability company (*Gesellschaft mit beschränkter Haftung, GmbH*) as the most popular and widespread German corporate forms. Using these corporate forms as an example, we then look at some persistent corporate law issues such as capitalization requirements, managerial duties, shareholders' liability and employees' participation rights. Furthermore, we illustrate the process of designing a GmbH's articles of associations to the benefit of the shareholders and we provide a brief introduction into the regulations governing capital market transactions in Germany. After addressing some key aspects of corporate acquisitions in the fourth chapter, we discuss some typical problems faced by companies engaged in cross-border activities, including the relevant EU framework, in the fifth chapter. The supplementary materials include some recommendations for further reading, selected bilingual excerpts of important statutes, as well as examples of some important corporate documents.

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Introduction

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Abstract

In the following first chapter, we will provide an introduction to the legal and economic environment to be aware of when considering doing business in Germany. Beginning with a short summary of the economic framework conditions of the German market, we will explain some basic features of the German legal system, including the structure of the legislative and judicial system, and will describe some of the most important legal frameworks. Thereupon, we will outline some of the key aspects of German business law to be considered when deciding upon establishing a business enterprise in Germany. We will continue our presentation by introducing the main options for foreign entrepreneurs to this purpose, by outlining the requirements for establishing a branch office for an existing foreign company as well as by a brief presentation of the most important non-corporate and hybrid forms of German business organizations available. Finally, we will provide a brief introduction into the German legal framework governing insolvency and restructuring of companies as a matter of utmost practical importance for any business operation.

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1.1 Conducting Business in Germany

1.1.1 Case Study

Case Study

A-Corporation (***A***) is incorporated in the state of Delaware, USA, with its headquarters in Wilmington. **A** manufactures components for automobile brakes. **A** conducts business throughout the US and is considering a future expansion of its business into Europe. John B. (***B***), the CEO of **A**, is interested in Germany in particular. He has visited the International Automobile Fair in Frankfurt/M. and has gained the impression that Germany would be well suited for the sale and distribution of **A**'s products. **B** was especially impressed by the number of visitors to the Frankfurt Fair interested in automobiles. Seeing them as potential buyers (of cars and their components, such as **A**'s products), **B** calls Peter C. (***C***), head of A's legal department, to ask him to prepare a memorandum on the framework for doing business in Germany.

B asks **C** to address the following issues and questions:

- Elaborate on the general economic background and business climate in Germany.
- What advantages does Germany have to offer to a foreign investor?
- What are the key features of German business law?

1.1.2 Economic Background

Germany is one of the world's leading industrial nations and, e.g. in terms of total economic output, Germany is also one of the leading economies within Europe. In 2009, Germany exported goods amounting to EUR 803.2 billion and imported goods amounting to EUR 667.1 billion. Germany has a highly developed free market system; its economy is closely linked to the other Member States in the European Union. Trademarks of Germany's economic system are its highly developed infrastructure, its qualified workforce and its international, export-oriented focus.

Many German companies generate a great deal of their profits through exports and many jobs are dependent on foreign trade. From 2003 until 2008, Germany was the world export champion ('*Exportweltmeister*') since no other country exported more goods to other countries during this time period.[1] In 2009, China surpassed

[1] Source: German Federal Statistical Office (Statistisches Bundesamt), Export, Import, Globalisierung, 2010, p. 37.

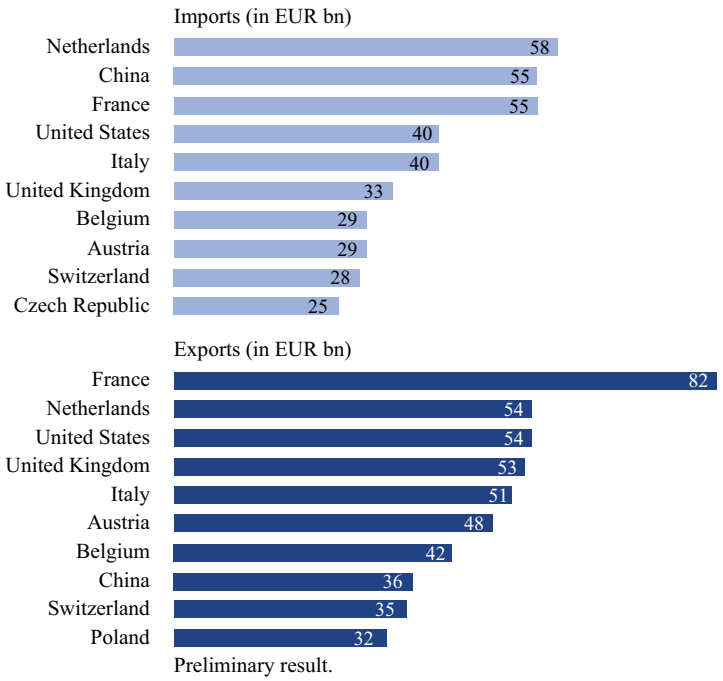

Fig. 1.1 Germany's major trading partners in 2009. (Source: Statistisches Bundesamt, Wiesbaden 2010)

Germany, however, Germany was second, still ahead of the US. Also, with regard to the import of goods, Germany remains one of the leading countries worldwide; in 2009 only the US and China imported goods with a higher aggregate value.[2] For this reason, Germany has traditionally been attractive to foreign investors looking for business opportunities in Germany. Germany's most important trading partners are EU Member States like France and the Netherlands.[3] Almost three out of four goods 'Made in Germany' are delivered to European countries. In 2009, 63% of goods were delivered to EU Member States. However, in 2009 the second important market for German products was Asia with a share of about 14%, ahead of the US market with a share of about 10% (Figs. 1.1 and 1.2).

In an advanced economy such as that of Germany, business organizations are important economic and social institutions. The success of these business organizations obviously depends on the legal framework surrounding them. Since Germany is a member of the European Union, cross-border commercial activities in the European market and the resulting legal issues become more and more important for investors in the German market.

[2] Source: World Trade Organization (http://www.wto.org./english/res_e/statis_e/its_e.htm).

[3] Source: German Federal Statistical Office (Statistisches Bundesamt), Wiesbaden 2010.

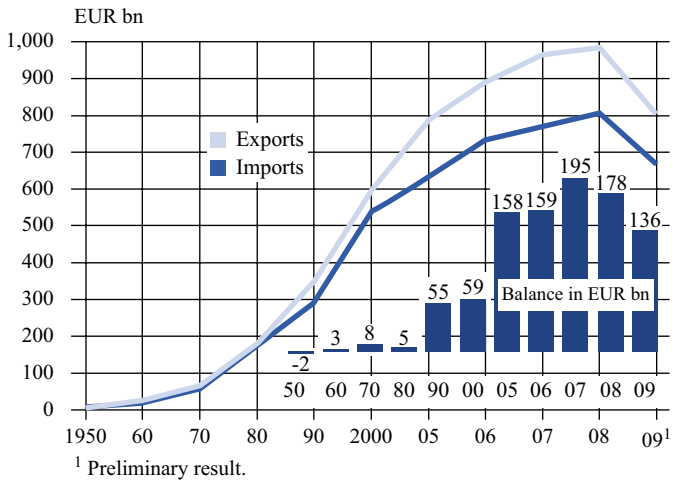

Fig. 1.2 Development of German foreign trade from 1950 to 2009. (Source: Statistisches Bundesamt, Wiesbaden 2010)

1.1.3 Core Features of the German Legal System

As its name suggests, the Federal Republic of Germany is organized as a federal system consisting of 16 federal states (*Bundesländer*), each of which is responsible for the government of its own state, including law-making powers in many areas, provided that they are not preempted by Federal law.

Furthermore, Germany is a Member State of the European Union (EU). This is the association of a large number of European states and, as such, the impact of European law on many areas of national law has become more and more important. This is particularly true for those areas of EU law which are either directly or indirectly applicable, such as EU Regulations or the Directives. It is also true for the case law of the European Court of Justice (ECJ) which often plays a decisive role in legal disputes when the national courts of EU Member States have to interpret the scope of applicability of the Union Treaties.

1.1.3.1 Hierarchy of Norms and Constitutional Framework

In Germany, the highest written national norm is the Federal Constitution. The Constitution or so-called 'Basic Law' (*Grundgesetz, GG*), which was promulgated by the Parliamentary Council on 23 May 1949, defines and regulates the political and legal system of the Federal Republic of Germany (Fig. 1.3).

Germany is a republic and a democracy; it is a federal state based on the rule of law and social justice. The *Grundgesetz* contains a catalogue of fundamental rights and values to be protected against any form of infringement, such as the dignity of man, freedom of religious belief, freedom of speech, freedom of arts and sciences, freedom of assembly, freedom of association, the right to freely choose one's profession, the principle of equality before the law and a constitutional guarantee

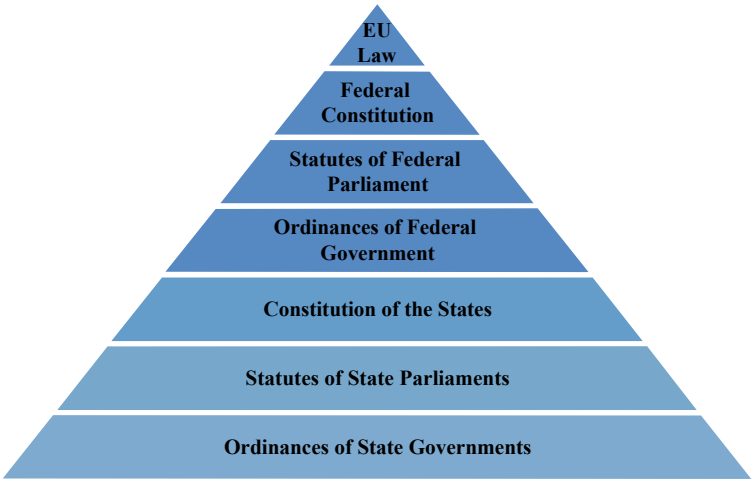

Fig. 1.3 Hierarchy of norms

of private property. These fundamental rights are binding as to legislation, judicial decisions and the executive branch as law with immediate effect. Depending on the nature of the fundamental rights, they are not only applicable to individuals but also to legal persons such as corporations.

The *Grundgesetz* also includes the law on voting rights, citizenship, political parties and the regulation of the functioning of the various organs of state such as the Federal Parliament (*Bundestag*) and the Federal Council (*Bundesrat*), the Federal President (*Bundespräsident*), the Federal Government (*Bundesregierung*) and the Federal Chancellor (*Bundeskanzler*). However, the *Grundgesetz* does not prescribe any specific form of economic order (such as a free market economy) but is considered neutral from an economic policy perspective.

The fundamental rights and values codified in the *Grundgesetz* are primarily designed as providing protection for the individual against any infringement of her/his guarantees by the government, regardless whether such infringement results from a legislative act, any form of executive power or from the judiciary. However, the *Grundgesetz* may also have an impact on the legal relationships between private individuals or business entities. This so-called third party effect (*Drittwirkung*) was developed by the *Bundesverfassungsgericht* (Federal Constitutional Court) in the famous *Lüth*-decision of 1958.[4] Dealing with the question whether a civil law injunction based on Sec. 826 of the German Civil Code (*Bürgerliches Gesetzbuch, BGB*) violated the complainant's fundamental right of free speech under Art. 5 of the *Grundgesetz,* the court held that the civil courts should interpret the provisions of the *BGB* in the light of the *Grundgesetz*, since the Constitution represents an objective set of values always to be taken into account when deciding legal issues. Based on this concept of third party effect of fundamental constitutional rights, the

[4] BVerfGE 7,198, 15 January 1958, 1 BvR 400/51—*Lüth*.

Bundesverfassungsgericht, as the guardian of the Constitution, has invalidated various legal provisions on the grounds that they were incompatible with the Constitution (e.g. with respect to discrimination against gender, age etc). More generally, the Constitution always plays an important role when statutes need to be interpreted. If a statutory provision is amenable to several different interpretations, then the interpretation which would make the law compatible with the Constitution is always to be preferred. Constitutional law has, therefore, traditionally played an important role in civil law and business law.

Next in rank from the Constitution is statutory law in the form of statutes passed by the Federal parliament (*Gesetz im formellen Sinne*). Thereafter come ordinances passed by the Federal government (*Bundesrechtliche Verordungen und Satzungen*). Although they are not a product of the parliamentary process but passed by administrative authorities, these ordinances are abstract rules which are generally applicable to many cases. Therefore, they are regarded as statutes in a material sense (*Gesetz im materiellen Sinne*). Due to Germany's structure as a federal republic, consisting of 16 federal states (*Bundesländer)*, the same hierarchy of norms can be found at each state level, starting with the respective state constitution and followed by statutes (*Gesetze der Länder*) and ordinances (*Landesrechtliche Verordungen und Satzungen*) of the respective state. As a general rule, federal law always takes precedent over state law (see Art. 31 GG). This means that if the law of a particular German state collides with a law made by the Federal Government, then the federal law will prevail. Subordinate legislation at federal level will take precedence even over the constitution of a state, insofar as the Federation has the competence to pass a law on the matter in question.

1.1.3.2 Predominance of Federal Law

As indicated, and similar to the US, Germany has a federal system with the law-making powers divided between the federal government (*Bund*) and the individual German states (*Länder*). However, (unlike the US) in most areas of civil, commercial and business law, the law-making power lies with the federal government. As Germany belongs to the family of so-called civil law systems, the legal landscape has traditionally been dominated by comprehensive codes and statutes promulgated by the legislature in all major areas of the law. Most areas of civil, commercial and business law are, therefore, covered by federal statutes issued by Germany's Federal Parliament. As one obvious advantage of such predominance of federal law, market participants will find a uniform legal framework for business throughout Germany (in contrast to the diverse legal landscape e.g., in the US). We will, therefore, look at the relevant statutory regulations and also discuss the question whether, in some cases, the statutory regime for a specific company form has been altered by the courts with judge-made rules or may be altered by the shareholders by contractual provisions.

1.1.3.3 Distinction Between Public and Private Law

Derived from its historical origins in Roman law, the German legal system still remains characterized by the distinction between private and public law, both areas

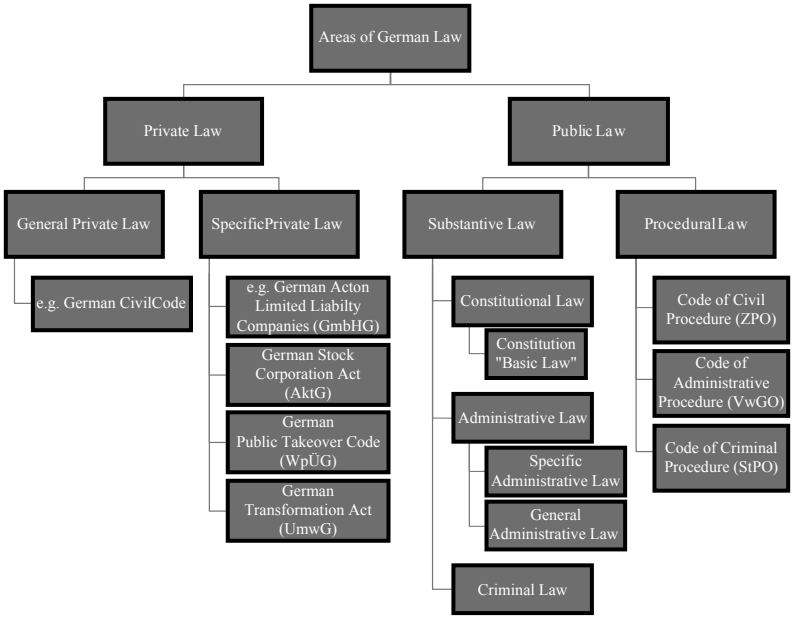

Fig. 1.4 Areas of German law

of law covering different legal issues and being dealt with by courts with different jurisdictions. Public law is usually defined as the embodiment of those rules conferring powers and imposing obligations exclusively on holders of public office. This means in particular the federal government, the German federal states and supranational organizations such as the European Union. On the other hand, private law is directed at all legal subjects (Fig. 1.4).

Public Law

Public law covers areas such as constitutional law, administrative law, tax law and social security law. Public law also includes the general principles of administrative law, as well as its various specialized fields, such as police law, the law of communal administration, public construction law and the law relating to foreigners and asylum. Data protection law, public service law, media law, traffic law, environmental law, the law of taxation and procedural law are also included. Furthermore, criminal law is also considered as a part of public law, since only the state has the authority to inflict punishment.

Private Law—General and Specific Regulation

Private law generally governs one's private legal affairs such as entering into contracts, acquiring and transferring property, receiving compensation for injuries, or establishing a business. German private law is regulated in numerous individual statutes dealing with general issues of private law such as contracts, property or

compensation for damages and specific issues of private law like intellectual property, labor law or the law of business associations.

The most important statutory regulation in the area of private law is the German Civil Code (*Bürgerliches Gesetzbuch, BGB*) comprising more than 2,300 sections and covering, among others, the law of contracts, the law of torts, property law, family law and the law of succession. In Germany (as in many other jurisdictions), private law is based on the fundamental assumption of private autonomy, i.e., the idea that legal subjects should, in principle, be free to arrange their private legal affairs and the law should provide institutions like contract, ownership and business forms to facilitate this freedom. However, the history of private law is also a history of defining the limits of such freedom in order to protect certain interest groups which (in the eyes of the courts and the legislature seem to) need specific legal protection, e.g. consumers, employees or creditors.

German Civil Code (*BGB*)

The German Civil Code came into force on 1 January 1900 and can be seen as a result of the unification process and of the codification movement of the 1900s. The codification movement originated in the age of enlightenment and also produced other famous European codifications of Civil Law, such as the French Civil Code of 1804 (the so-called '*Code Napoleón*') or the Austrian General Civil Code (*Allgemeines Bürgerliches Gesetzbuch*) of 1811.

From the time of its enactment until today, the BGB has been amended numerous times in order to adapt the legal framework to the ever-changing political, social and economic environment. Typical amendments are the introduction of specific regulations protecting certain interest groups like consumers, employees and tenants. With ongoing European integration, further changes have become necessary to implement rules under mandatory European law, including a particularly important reform in 2002 (the Act on the Modernization of the Law of Obligations, *Schuldrechtsmodernisierungsgesetz*). However, in many respects the BGB still reflects some of its historical legal concepts, in particular, some classic ideas of '*laissez faire*'—liberalism, such as the notions of private autonomy and freedom of contract. Although private autonomy and freedom of contract are still regarded as the cornerstones of German private law, the original ideas of the authors of the BGB based on the rather idealistic (and somewhat artificial) concept of a contract formed by two legal subjects with equal bargaining power freely negotiating the terms of their agreement with each other. This concept had been subject to criticism even at the time of its origin, as it completely ignores social realities, and, in particular, the widespread inequality of bargaining powers between contracting parties, such as employees and employers, tenants and landlords or consumers and manufacturers. Thus, the history of the German Civil Code can be seen as a history of expanding protection of the 'weaker party' and, as of today, the BGB reflects an interesting amalgam of different—and in part conflicting—value sets and concepts.

Among other things, the BGB regulates general issues of contract law, as well as specific types of contracts, such as purchase, lease, service, manufacturing, surety-

ship, civil law partnership, negotiable instruments, transfer of title and real property and damages or claims for restitution in cases of unjust enrichment.

As it has been often criticized for its rather sophisticated and technical language, the BGB does offer the advantage of having quite a clear and systematic structure. The *BGB* consists of five books and begins with a book of general provisions (*Allgemeiner Teil*). This deals with fundamental concepts and issues of private law, such as the definition of general legal capacity, the definition of legal subjects and objects, the specific requirements for legal transactions (in particular for contracts), the law of agency (*Stellvertretung*) and provisions relating to limitation periods (*Verjährung*). These fundamental definitions and concepts apply to all the following sections of the *BGB*. The second book covers the law of obligations (*Schuldrecht*) and is subdivided into a general and a specific part. The general part contains rules on the performance of contracts, remedies for non-performance, rules on the transfer of rights and duties and rules on transactions involving several creditors or debtors. The specific part deals with certain specific types of contracts, such as purchase agreements (*Kaufvertrag*), leasehold contracts (*Mietvertrag*), contracts for services and for specific services (*Dienst- und Werkvertrag*) and loan agreements (*Darlehensvertrag*). The specific part also includes rules on the compensation for delicts for unjust enrichment. The third book of the BGB deals with the law of property (*Sachenrecht*) comprising the legal relationships between persons and things, e.g. the right of ownership, titles of possession and other rights *in rem*, such as mortgages. The fourth book contains family law and deals with the law of engagement, marriage, divorce and the law of custody of children, and the fifth book contains the law of succession (*Erbrecht*).

The German Civil Code distinguishes between consumers (*Verbraucher*), meaning any natural person who enters into legal transactions for a purpose outside her/his trade or profession[5], and entrepreneurs (*Unternehmer*), defined as a natural or juristic person or a partnership with legal personality who or which acts in exercise of her, his or its trade when entering into a legal transaction.[6] Consumers are often protected by specific legal provisions, e.g. with regard to specific information rights or specific rights to withdraw from contractual obligations. One prominent example is the law on standard terms of contract (*Allgemeine Geschäftsbedingungen* or *AGB*).[7] Such AGB are of considerable practical significance, as numerous businesses associations use these standardized legal tools when dealing with their customers. In order to address the risks associated with using standard terms for the contract party being subjected to them (i.e. unfair surprise by disadvantageous contract terms), German law provides for specific requirements regarding the inclusion of AGB into a contract, as well as several control mechanisms regarding their content. In principle, the provisions on standard terms apply to consumers and entrepreneurs alike. However, the level of protection provided for consumers and entrepreneurs varies considerably, since entrepreneurs and business associations are considered to have

[5] See Sec. 13 BGB.

[6] See Sec. 14 BGB.

[7] Or, as they are also-called, general terms of business/conditions of business.

sufficient legal knowledge to negotiate effectively and enter into agreements, i.e. they do not require the same level of protection as consumers. Therefore, only specific provisions of the law on AGB will apply to them, for example, the invalidation of terms which unreasonably discriminate against the contractual partner contrary to the requirements of good faith and fair dealing (Sec. 307 BGB).

German Commercial Code (*HGB*)

With regard to other important areas of private law, such as commercial law, the German Commercial Code (*Handelsgesetzbuch, HGB*) contains specific rules for so-called 'merchants' (*Kaufleute*), i.e. anyone who carries out a commercial activity (as defined by Sec. 1 HGB) regardless of the field of commercial activity (e.g. production, trade, services) and for commercial transactions related to them.[8] The HGB contains special rules providing for the specific needs of commercial life.[9] For example, a different treatment of commercial transactions is justified, since businesspeople often expect and rely on speedy transactions.

In addition, since merchants are expected to have some basic commercial and legal understanding for business operations (in contrast to consumers), they supposedly do not require the same extent of legal protection as ordinary citizens. The HGB, therefore, contains various deviations from the general rules of the German Civil Code, e.g. regarding the level of the duty of care owed by merchants or the requirements for binding contracts with regard to form. The Commercial Code is limited to the buying and selling of goods, but also comprises other areas of business life, such as transport, banking and insurance industries, manufacturing and craftsmanship.

Sources of Corporate Law

Unlike other European jurisdictions, such as e.g. the UK, Germany has no single act or codification regulating all companies and business associations, but has several statutes for various types of business associations (with or without corporate form).

The statutes most relevant to business organizations without corporate form in Germany (such as the civil law partnership or the commercial partnership) are the German Civil Code and the Commercial Code. Apart from the legal areas already mentioned above, the German Civil Code also regulates so-called civil law partnerships (*BGB-Gesellschaft* or *GbR*). The HGB includes rules for specific business forms, such as the general commercial partnership (*offene Handelsgesellschaft* or *oHG*), the limited commercial partnership (*Kommanditgesellschaft* or *KG*) and the silent partnership (*Stille Gesellschaft*).

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[8] An exception is made for private practitioners as defined under Sec. 18 German Income Tax Act (*Einkommenssteuergesetz, EStG*), to whom the Commercial Code is not applicable, regardless of the size and success of their enterprise, e.g. attorneys-at-law, architects or medical doctors.

[9] The legal distinction between merchants and non-merchants as set forth in the HGB is not identical to the legal distinction between entrepreneurs and consumers within the meaning of the BGB; while a merchant will nearly always also be considered as an entrepreneur under the BGB, such entrepreneur may—due to the size or nature of her/his business—well not qualify as a merchant according to Secs. 1 *et seq.* HGB.

Corporations, on the other hand, are regulated in specific statutes. The Stock Corporation Act (*Aktiengesetz* or *AktG*) governs the German stock corporation (*Aktiengesellschaft* or *AG*), as well as the commercial partnership limited by shares (*Kommanditgesellschaft auf Aktien* or *KGaA*), the latter being a stock corporation with fully liable general partners. In addition, the Stock Corporation Act regulates affiliated companies and determines the level of liability among parent companies and their subsidiaries.

The Limited Liability Company Act (*GmbH-Gesetz* or *GmbHG*) sets out the rules for the German Limited Liability Company (*Gesellschaft mit beschränkter Haftung* or *GmbH*), which is the most popular German corporate form, especially for small and medium-sized businesses.

Moreover, the Transformation Act (*Umwandlungsgesetz* or *UmwG*), set into force in 1994, sets out provisions for reorganizations of legal entities, namely by way of mergers (*Verschmelzungen*), divisions (*Spaltungen*), comprehensive transfer of assets (*Vermögensübernahmen*)[10] and changes of corporate form (*Formwechseln*).

Negotiable Instruments

In addition to the BGB and the HGB and some other important statutes in the area of company law (which will later be discussed in more detail), there are several other statutes which are relevant for conducting business, some of which should be briefly mentioned. One such area is the law governing negotiable instruments.

The legal rules regarding negotiable instruments and securities (*Wertpapierrecht*) are contained in various statutes, including the German Civil Code, Commercial Code, the Bills of Exchange Act (*Wechselgesetz*), the Checks Act (*Scheckgesetz*), the Stock Corporation Act (*Aktiengesetz*), and the Securities Deposit Act (*Depotgesetz*).

Competition and Antitrust Law

Competition law is governed by the Unfair Competition Act (*Gesetz gegen den unlauteren Wettbewerb*) and deals with various forms of competition which are considered to be unfair. This regulation aims to protect a functioning market economy. It also intends to protect individuals and business associations against unfair practices by competitors and to protect consumers against the risk of being misled and overcharged. Any person whose trade practice is classified as unfair competition (*unlautere Wettbewerbshandlung*) can be prevented from doing so by way of injunction and may also be liable for damages. Antitrust law (*Kartellrecht*) is also directed primarily at the protection of a functioning market economy; its main goal is the prevention of cartels and unfair restrictions of competition. In Germany, it is regulated in the Act against Restrictive Trade Practices (*Gesetz gegen Wettbewerbsbeschränkungen*) together with provisions of European Union law governing cartels and mergers.

[10] The rules on restructuring by way of a 'comprehensive transfer of assets' as defined in the act are intended to provide specific rules for privatizations of state industries. In other areas of practice they are of little relevance.