



# Forum Juris Special

## German Merger Act Update

New provisions dealing with cross-border mergers

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## German legislator finally clears way for cross-border mergers

International businesses do not stop thinking at national borders. In their strategic and structural plans, they often include measures related to businesses which have their registered offices in various EU-Member States. Until now, any merger of such businesses “under one roof” involved a number of difficulties and the possibility to achieve a merger was limited.

It is true that, in its SEVIC-Judgement, the European Court of Justice had ruled „that Articles 43 EC and 48 EC preclude registration in the National commercial register of the merger by dissolution without liquidation of one company and transfer of the whole of its assets to another company from being refused in general in a Member State where one of the two companies is established in another Member State (...)”. Nevertheless, in reality, the implementation of a real cross-border (legal) merger involved a number of practical difficulties caused by the lack of statutory provisions of German law.

Therefore, in German legal practice, businesses often made use of alternative options. Instead of implementing a cross-border merger, the parties opted for asset transfers followed by the subsequent liquidation of the remaining empty shell. The so-called accretion construction (*Anwachungs-Modell*) was also used, by which a corporation (such as the *Gesellschaft mit beschränkter Haftung* or *Aktiengesellschaft*) was converted into a (limited) partnership (in most cases a “Foreign Corporation & Co. KG”, in which a foreign corporation, such as a Dutch B.V. or an English Private Company Limited by Shares acted as sole General Partner) in order to subsequently implement an accretion by which the limited partnership's assets transferred to its sole general partner, the foreign corporation.

In many cases, however, these arrangements had a number of disadvantages. For example, under German law, an asset transfer does not lead to a transfer of assets to the acquiring company by means of universal succession (*Gesamtrechtsnachfolge*) but has to be viewed as a transfer of each and every asset and liability.

Now, the German legislator has finally acted and ahead of the deadline fulfilled its obligations deriving from the Merger Directive (Directive 2005/56/EC of the European Parliament and of the Council of 26<sup>th</sup> October 2005 on cross-border mergers of limited liability companies) by way of implementation of the Second Act related to changes of the German law on transforming companies (*Zweites Gesetz zur Änderung des Umwandlungsgesetzes*).

Under the new law, it will be a lot easier to merge German businesses with businesses in other EU and EEA Member States by means of a cross-border merger as defined in the Merger Directive. This is already true for mergers with an entity with its registered offices in EU or EEA Member States which have already implemented the Merger Directive. Once the period for the implementation of the Merger Directive will have lapsed in December 2007, the same will then be true for all EU and EEA Member States.

In the future, it will therefore be possible that – by way of example – a German GmbH is merged with its UK-based holding company having the legal form of a UK Limited or that a Spanish S.L. is merged with a German Stock Corporation.

With respect to the merger of German entities with entities which are based in Member States which have not yet implemented the Merger Directive, the new law will significantly increase the legal certainty for the parties. In these cases, it will now only be necessary to resort to the principles of the SEVIC-Judgement for one of the participating entities, i.e. the non-German entity participating in the merger.

Unfortunately, when implementing the Merger Directive, the German legislator has not seized the opportunity to also implement statutory provisions for cross-border demergers/divisions. The principles established by the ECJ in its SEVIC-Judgement will continue to apply to demergers/divisions. Leading authors in Germany are of the opinion that, based on these principles, the implementation of a cross-border demerger/division is, in principle, admissible.

Besides the creation of a statutory regime for cross-border mergers, the new law will also bring about changes with respect to individual provisions of the German law on reorganisations (*Umwandlungsgesetz*). On the basis of these new regulations, it will become easier to merge sister-companies as well as to perform demergers/divisions in the form of a split-off (*Abspaltung*) or a drop-down (*Ausgliederung*).

Even after the Merger Directive will have been implemented in all EU and EEA Member States, cross-border mergers and demergers/divisions will require utmost diligent preparation. This is in particular true for the analysis of the tax consequences of such merger or demerger/division as well as for the consequences with respect to employee participation in the acquiring/surviving entity.

With greater opportunities to do cross-border transactions, we should be more than happy to assist you in the planning, the preparation and the implementation of cross-border mergers and demergers/divisions. Through our international network, we can ensure that you will be provided with high quality reliable legal advice "at either side of the border".



## 1. Statutory regime for cross-border Legal Mergers

### 1.1. Background

Paragraph 1 of the German law on transforming companies (*Umwandlungsgesetz*) of 28<sup>th</sup> October 1994 (BGBl. 1994 I., p. 3210), as amended in 1995 and subsequently (the “German Merger Act”) headed “types of transformation, statutory restrictions”, currently provides: “(1) Legal entities established in Germany may be transformed 1. by merger, 2. by de-merger [division], 3. by transfer of assets, 4. by change of legal form.”

On the basis of these provisions of statutory law, the prevailing opinion in German legal literature and jurisprudence held that a merger of a German entity with a non-German entity was not admissible.

In spite of this fact, in the past, in Germany there have been several attempts to implement mergers involving both German and non-German entities. In most cases, these attempts related to group entities, in which problems with respect to minority shareholders/outsideers could not arise and employee participation issues could be avoided. In some cases – mostly where a German entity acted as acquiring entity, which from a German point of view is considered “less dangerous” – these mergers were, in fact, successfully implemented and registered with the competent commercial register.

At least one attempt, however, could not be successfully implemented in the beginning. The competent German commercial register (*Amtsgericht*), based on Paragraph 1 German Merger Act, refused to make the registration in the German commercial register (which according to German law is necessary for the merger to become effective). The company in question then brought an action against that rejection decision before the competent Regional Court (*Landgericht*). In those circumstances, taking the view that resolution of the dispute before it

depended on the interpretation of Art. 43 EC and 48 EC, the competent *Landgericht* decided to stay the proceedings and refer the question to the ECJ.

This finally led to the SEVIC-Judgement, in which the ECJ ruled that Art. 43 EC and 48 EC preclude registration of cross-border mergers from being refused in general.

Simultaneously, the European legislator on 25<sup>th</sup> November 2005 had implemented the Merger Directive (Directive 2005/56/EC of the European Parliament and of the Council of a 26<sup>th</sup> October 2005 on cross-border mergers of limited liability companies). The Merger Directive will have to be implemented in national legislation by December 2007.

On February 1, 2007, the German Parliament (*Bundestag*) approved of the bill for a Second Act related to changes of the German law on transforming companies (*Zweites Gesetz zur Änderung des Umwandlungsgesetzes*), as prepared by the German Federal Government (*Bundesregierung*).

On March 9, 2007, the *Bundesrat* (representation of the German *Bundesländer*) decided not to appeal against the parliamentary bill by appealing to the resolution committee (*Vermittlungsausschuss*).

Therefore, it is to be expected that the parliamentary bill will soon be published and (one day after publication) enter into effect.

### 1.2. Implementation of the Merger Directive

The Merger Directive is being implemented in such way that a new title is inserted into Book Two of the German Merger Act, dealing with mergers.

This means that a cross-border merger will be codified as a sub-category, i.e. an additional alternative of a (regular domestic) merger. Accordingly, due to the provision contained in Paragraph 122a sub-para. 2 of the new wording

of the German Merger Act, a cross-border merger will, in principle, be subject to the same provisions as are applicable to (regular domestic) mergers, unless Paragraphs 122a through 122l German Merger Act provide otherwise.

### 1.3. Scope of Applicability

The Merger Directive defines a cross-border merger as an operation whereby (i) one or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to another existing company or a company that they form, in exchange for the issue to their members of securities or shares representing the capital of that other or new company or (ii) a company, on being dissolved without going into liquidation, transfers all its assets and liabilities to the company holding all the securities or shares representing its capital (Art. 2 Merger Directive).

The statutory provisions for cross-border mergers apply to all mergers of limited liability companies (as defined in Art. 2 of the Merger Directive) formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the community, provided at least two of them are governed by the laws of different Member States.

### 1.4. Foreign entities with their central administration or principal place of business in Germany

According to the wording of the new regulations of the German Merger Act, it is not compulsory that the companies participating in the merger have their central administration or principal place of business in various Member States.

Hence, it should also be possible to merge a German company with a foreign company which has its central administration or principal place of business in Germany (pseudo foreign company, for example, a Dutch B.V. or a UK Limited with its central administration and/or principal place of business in Germany).



### 1.5. Merger of several domestic entities with a newly-formed non-German entity

The wording of Paragraphs 122a and 122b German Merger Act does not explicitly exclude the possibility of a merger in which several German entities are merged with a third non-German entity to be newly-formed in the merger.

It appears, however, that it is not admissible to directly base such merger on the new articles of the German Merger Act. This is because in its reasoning the German legislator has clearly stated that the scope of applicability of the new Paragraphs of the German Merger Act shall be in line with the Merger Directive and the Merger Directive does not comprise the option discussed above (see the definition in Art. 2 Merger Directive). Whether it will be possible to implement such merger on the basis of European law and the principles of the SEVIC-Judgement will yet have to be proven in practice.

## 1.6. Partnerships

Neither the regulations of the Merger Directive nor the regulations contained in the new German Merger Act provide for the possibility of a partnership acting as participating party to a cross-border merger.

From a German perspective, this is regretful, because, in German practice, the limited partnership in the form of a GmbH & Co. KG plays a significant role. Moreover, the prevailing opinion in German legal literature holds that it can be concluded from the SEVIC-Judgement that it is a requirement of European law to also admit partnerships to participate in cross-border mergers.

Given that the new law does not have any provisions governing a cross-border merger with a partnership as participating entity, it is recommendable to resort to auxiliary options, for example, first converting the partnership into a corporation (company with limited liability) by means of a change of legal form (as provided for in the German Merger Act) and then proceed with the cross-border merger. It goes without saying that this will add to the difficulty of such merger and that the tax and employee participation issues related to a conversion of the partnership into a corporation will have to be assessed in detail prior to its implementation.

## 1.7. Operations which count as merger

There is still some uncertainty whether the Merger Directive and the new German Merger Act comprise all options for a merger which are known to German law.

This has to do with the definition of merger as contained in Art. 2 Merger Directive and is in particular true for so-called down-stream mergers (i.e. a merger of a parent company with its subsidiary) and certain variants of side-stream mergers (i.e. a merger of a company with its sister-company), during which, in accordance with the new provisions of the German Merger Act (see below), no capital increase is being executed and no shares are being distributed.



## 1.8. Procedure

The procedure to be observed in the case of a cross-border merger is, in principle, similar to the procedure that has to be observed in the case of a domestic merger.

In partial deviation from the provisions related to domestic mergers, however, according to Paragraph 122c German Merger Act, instead of a merger agreement, common draft terms of the cross-border merger are to be jointly prepared by the management of the corporations participating in the merger (*Verschmelzungsplan*, "Merger Plan"). The Merger Plan, among others, has to contain (i) the details of the participating corporations; (ii) the exchange ratio of the shares and the amounts of cash compensations, if any; (iii) details of the issuance of shares by the acquiring entity and the date as of which these newly-issued shares shall be entitled to profits; (iv) the effects of the merger on the employees; (v) the effective date of the merger; (vi) the treatment of holders of preferred shares and bonds; (vii) the articles of association of the acquiring /surviving corporation; (viii) detailed regulations on the employees' co-determination rights in the acquiring/surviving corporation; (ix) the Merger

Balance Sheet Effective Date and (ix) information on the valuation of the assets and liabilities of the transferring/merged corporation.

The Merger Plan must be notarised and be published in the manner described by the laws of each Member State at least one month before the date of the general meeting which is to decide thereon. In addition, the legality of the cross-border merger will have to be scrutinised by the court, notary or other authority designated by each Member State as regards that part of the procedure which concerns each merging company subject to the applicable national law. In Germany, the legality of the cross-border merger will be scrutinised by the commercial register, which will also issue the premerger certificate stipulated in Art. 10 Merger Directive and Paragraph 122 k German Merger Act.

The merger will become effective upon its registration with the commercial register of the acquiring entity or – if the acquiring entity is subject to the provisions of foreign law, which provisions provide for other requirements for the becoming effective of the merger – upon satisfaction of these requirements.

#### 1.9. Compensation in cash

According to Paragraph 122i German Merger Act, where the acquiring entity will not be subject to the laws of Germany, the acquiring entity must, in certain circumstances, offer the shareholders of the entity to be merged a compensation in cash.

#### 1.10. Special provisions aimed at the protection of creditors for cases where the acquiring entity will not be subject to the laws of Germany

According to Paragraph 122j German Merger Act, where the acquiring entity will not be subject to the laws of Germany, with respect to certain claims of the creditors of the company to be merged, the acquiring entity must provide for security, unless the creditors can demand satisfaction of their claims.

This provision can lead to a situation where, long before the merger becomes effective upon its registration with the commercial register, the acquiring entity must provide security.

These regulations for securities to be granted in the case of a cross-border merger go beyond the provisions dealing with the same issues in the case of domestic mergers.

#### 1.11. Employee participation

The regulations related to employee participation are to be found in Art. 16 of the Merger Directive.

The German legislator has implemented the Merger Directive by means of the Act related to Employee Participation in the case of a Cross-Border Merger (*Gesetz über die Mitbestimmung der Arbeitnehmer bei einer grenzüberschreitenden Verschmelzung*, “MgVG”).

According to these regulations, in the case of a cross-border merger, the company resulting from the cross-border merger shall, as a general rule, be subject to the rules in force concerning employee participation, if any, in the Member State where the acquiring entity has its registered office.

However, at least for mergers involving German entities, this general rule will often not be applicable, because Art. 16 of the Merger Directive and the regulations of the MgVG provide for a number of exceptions. To the extent these exceptions apply, instead of the employee participation rules applicable to the acquiring entity, the employee participation model which has been developed for the Societas Europaea, i.e. the European Stock Corporation (the “SE Model”) shall apply. The SE Model will apply (i) where at least one of the merging companies has, in the six months before the publication of the draft terms of the cross-border merger, an average number of employees that exceeds 500 and is operating under an

employee participation system within the meaning of Art. 2 of Directive 2001/86/EC; or (ii) where the national law applicable to the acquiring entity does not provide for at least the same level of employee participation as operated in the relevant merging companies; or (iii) where the applicable national law does not provide for employees of establishments of the acquiring entity that are situated in other Member States the same entitlement to exercise participation rights as is enjoyed by those employees employed in the Member State where the acquiring entity has its registered office.

The SE Model is very complicated and cannot be described in more detail here. In essence, however, it can be said that it can lead to lengthy negotiations with employee representatives and, at least where German companies are involved in the merger, to a continuation of the far-reaching German employee participation model in the acquiring/surviving entity.

Therefore, the implementation of a cross-border merger will only in very few cases serve the often-desired goal of "being released" from employee participation models providing for co-determination, such as these for instance exist in Germany and – to a lesser extent – in the Netherlands.

#### 1.12. Tax consequences

The (German) tax consequences of a cross-border merger are regulated in the new law pertaining to tax measures related to the introduction of the European company and further amendments of other tax provisions, the so-called "SEStEG".

Although the SEStEG primarily serves to implement the changes in German law with respect to cross-border mergers that are required by European law, it also provides for numerous changes with respect to other provisions of German tax law which are also applicable to domestic cases.



The new regulations lead to the consequence that, as a general rule, for tax purposes, all mergers and demergers/divisions which have been applied for registration with the competent commercial register after December 12, 2006 are treated on the basis of fair market values. Only in cases where an application for taxation at lower (book) values is made and where it is safeguarded that the right to taxation – also with respect to hidden reserves – will remain with the German tax authorities, will there be a possibility to have the merger performed on the basis of book values or values between book value and fair market values. In the case of domestic mergers, these requirements will mostly be met. In certain circumstances, however, these requirements can also be met in case of a cross-border merger, thanks to the principle of taxation of permanent establishments and depending on the allocation of certain assets to the entities involved after the consummation of the cross-border merger for tax purposes.

The further details of the relevant tax provisions cannot be described in more detail within the scope of this Update.

### 1.13. Cross-border demergers/divisions

As regards domestic cases, the German Merger Act provides for three variations of a demerger /division, namely: (i) a split-up pursuant to Paragraph 123 sub-para. 1 German Merger Act, where the entire assets of the transferring entity transfer in parts to another existing or newly-formed acquiring entity and the shareholders of the transferring entity received shares or memberships in this acquiring entity (*Aufspaltung*); (ii) a split-off pursuant to Paragraph 123 sub-para. 2 German Merger Act where one or more parts of the assets of the transferring entity transfer to one or more acquiring or new entities, whereby the shares or memberships in this or these entities are received by the shareholders of the transferring entity (*Abspaltung*); or (iii) a drop-down, consisting in the transfer of one or more parts of the assets of the transferring entity to one or more acquiring or new entities, whereby the transferring entity will receive the shares or memberships of this or these acquiring entities (*Ausgliederung*).

The fact that the European and German legislators have, until now, not implemented any rules explicitly dealing with cross-border demergers /divisions does not mean that such cross-border demergers/divisions will not be feasible.

In the reasoning of its draft bill, the German legislator has made clear that it has refrained from enacting statutory provisions for cross-border demergers/divisions (solely) because of the fact that a solution for the relevant questions shall be found at a European level.

Accordingly, the non-enactment of the relevant provisions is not to be viewed as a decision of the German legislator against the admissibility of cross-border demergers/divisions. Indeed, the implementation of cross-border demergers/divisions will have to follow the principles that have been applied prior to the enactment of the new German Merger Act, i.e. will have to be based on European law and the principles established by the ECJ in its SEVIC-Judgement.

As already stated above, there are numerous German legal authors which are of the opinion that the admissibility of cross-border demergers/divisions is a requirement of European law.

Accordingly, it will be an – albeit less secure – option to implement such demergers/divisions. Due to the non-enactment of the relevant statutory provisions, however, it will be necessary to prepare such cross-border demergers/divisions with utmost care. It is desirable to discuss in advance such implementation with the competent national authorities (in Germany, the commercial register).

## 2. Other material changes

### 2.1. Merger without capital increase and issuance of shares

The German legislator has amended Paragraphs 54 and 68 German Merger Act in such way that, if all shareholders of the transferring entity waive their right to have a capital increase of the acquiring entity executed, there will be no need for the acquiring entity to execute a capital increase and issue shares to the shareholders of the transferring entities.

This will make intra-group mergers of one company with its sister-company significantly easier.

### 2.2. Elimination of certain restrictions for split-offs and drop-downs

The regulations contained in Paragraphs 131 subpara. 1 no. 1 sentence 2 and 132 German Merger Act, which German legal literature has often characterised as a disruptive factor for split-offs and drop-downs have been abolished.

Because of the regulations in case of split-offs and drop-downs, it had been unclear whether agreements entered into by the transferring entity which contained a clause which prohibited the transfer and assignment of claims as a consequence of the split-off or drop-down transferred to the acquiring entity or remained with the transferring entity.

Now, by abolishment of the aforementioned provisions, the German legislator has put an end to the discussion in German legal literature and has reinforced the application of the principle of universal succession inherent to German law on transforming companies also in the case of split-offs and drop-downs.

At the same time, the new regulations will lead to a situation where German courts will have to establish whether, and under which conditions, the other party to an agreement which transfers to the acquiring entity as a consequence of a split-off or drop-down will have the right to terminate such



agreement, for example by way of a termination for cause, based on the principle of good faith and equity (*Treu und Glauben*). Insofar, in its reasoning, the German legislator makes reference to the general rules of German law on obligations.

Against this background, it may be desirable to provide for certain protective clauses in future agreements.

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