Newsletter 02/2007

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Rechtsanwaltsgesellschaft mbH

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Dear Clients,

We are happy to send you the English version of our Juris Forum Newsletter in which we have assembled current legal topics and important court decisions which we hope will be of interest to you.

A central focus of this Newsletter is on the reform of the limited liability company law (GmbH-Gesetz) by the "German Act to Modernize Limited Liability Company Law and to Combat Abuse" *(Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen – MoMiG)* which is currently still a government bill but will soon be passed into law. The MoMiG will result in a variety of significant modifications in GmbH law, in particular with regard to formation, protection of capital and mobility. Our article will bring you up to date on the latest legal developments.

A second article describes the amendments made by the law to transpose the EU Markets in Financial Instruments Directive into national law *(Finanzmarktrichtlinie – Umsetzungsgesetz – FRUG)*.

The article called "Overview of recent Legal Developments on Cross-border Mobility from a German Perspective" gives you a concise overview of the arrangements under company law which are possible in Europe.

Finally we address the case of liability in the event of erroneous ad hoc announcements.

Should you have any questions on the articles in this edition, please do not hesitate to get in touch with your usual contact person.

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Reform of Limited Liability Company Law is Starting to Take Shape

On May 23, 2007, the German federal cabinet adopted the government bill of the Act to Modernize Limited Liability Company Law and to Combat Abuse *(Gesetz zu Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen – MoMiG).* With this first substantial amendment of GmbH law *(GmbH-Gesetz – GmbHG)* since the reform in 1980 the German federal government is striving for an extensive modernization of GmbH law which is intended to come into force in the first half of 2008 and lead to increased flexibility and deregulation as well as offer better protection against abuse, in particular in cases of insolvency.

Due to the right of establishment throughout the EU the legal form of the German GmbH is facing growing competition from similar corporate forms in the member states of the European Union where far less demands with respect to foundation formalities and raising capital are often required for such corporate forms like the English Private Company Limited by Shares (Ltd.), for example. MoMiG is supposed to increase the appeal of the GmbH in comparison with competing foreign corporate forms.

The main proposed modifications read as follows:

1. Facilitating and Speeding up GmbH Formation

a) Government Bill Includes Specimen Articles of Association as an Attachment to GmbH Law

In order to facilitate and speed up the formation of a GmbH the bill proposes that GmbHG should in future include **specimen Articles of Association** for straightforward standard cases as well as a **specimen application to the commercial register** for the companies formed in accordance with the specimen articles of association plus a draft for the shareholder resolution appointing the managing director and a draft for the list of shareholders to be submitted pursuant to Sec. 40 GmbHG (so-called "set of formation documents").

If the specimen articles of association is used to form a GmbH, the written draft of the agreement is adequate pursuant to Sec. 2, Subsection 1a, of the GmbHG government bill *(GmbHG-RegE)*. Instead of recording the documentation before a notary public it is sufficient in such cases simply to have the shareholders' signatures certified by a notary public. The formation of a GmbH is thus made much easier and less expensive.

However, it is only possible to use the specimen articles of association thereby saving cost and time if no other additions or modifications are made to the specimen text apart from the inserts in the applicable spaces. Any deviation means that the documentation must be recorded before a notary public.

The scope of application of this alternative formation is therefore restricted. The prearranged parameters of the specimen articles of association mean that they can only be used for a GmbH with a **maximum of three shareholders and only one managing director.**

The German Bundesrat (upper house of the German parliament) argued against the introduction of the specimen articles of association. It therefore remains to be seen whether the specimen articles of association will be included in the end.

b) Abolition of State Certificate of Approval as Precondition for Entry in Commercial Register

While an entry was hitherto made in the commercial register pursuant to Sec. 8, Subsection 1, No. 6 GmbHG, for companies with a business purpose requiring a permit (e.g. craftsman's businesses or restaurants) only when the state certificate of approval had been submitted, the government bill has now abolished this requirement. The formation of companies requiring a permit is thus made much easier and becomes faster.

The rather slow approval procedure hitherto determined the speed of the entire formation of the company. A GmbH with a neutral business purpose was therefore often formed to begin with in order to be able to carry out the initial actions for starting up the new company (e.g. renting business premises, hiring staff). Expense and bureaucratic input were then necessary to modify the articles of association to change the business purpose into the one requiring the permit. This will no longer be necessary in the future.

c) Restricting the Examination of Formation and Impairment Test

The introduction of a new Sentence 3 in Sec. 7, Subsection 2 GmbHG is intended to clarify that only the declaration by the managing director that the required amount of share capital has been paid in is sufficient and further evidence is generally not required. The impairment test for contributions in kind which is carried out by the court of registration pursuant to Sec. 9c, Subsection 1 GmbHG, will in future be restricted to the question whether there is a “not insignificant” overvaluation and thus brought into line with the legal situation in stock corporation law. The comprehensive examination of the valuation of contributions in kind which was hitherto required by law did not do justice to the matter of forming a GmbH and sometimes led to long delays until entries were made. This modification in the law also aims at considerably shortening the formation process for a GmbH.

d) Possibility to Register Head Office Abroad

By abolishing Sec. 4, Subsection 2 GmbHG and its parallel stipulation in stock corporation law (Sec. 5, Subsection 2 German Stock Corporation Act *(Aktiengesetz – AktG))*, the bill creates the possibility to register a head office (abroad) which is different from the registered office in the articles of association. The foreign subsidiaries of German companies can therefore be formed as a GmbH, for example. The bill thus

finally creates the same basic conditions for the German GmbH in comparison with its competing foreign corporate forms. Regardless thereof, it still remains the case that a business address in Germany must be entered in the commercial register for the company and that this address must be sustained.

2. Liberalizing Regulations for Raising Capital

The MoMiG government bill foresees an extensive modernization of the system of share capital for a GmbH.

a) Reducing Minimum Share Capital and Minimum Nominal Value of a Share

The minimum share capital is reduced in Sec. 5, Subsection 1 GmbHG-RegE from previously Euro 25,000 to Euro 10,000. The reduction to Euro 10,000 is intended both to take account of the function of the minimum share capital as a threshold of trustworthiness and the demands for an adjustment to modern times with respect to the fact that many companies have moved from manufacturing to services.

It is also intended to dispense with the previous minimum nominal value of a share of Euro 100. The only minimum precondition would then be in future that the nominal value of each share is counted in whole Euros, i.e. it should amount to at least one Euro.

b) Creating a So-Called Limited Liability Entrepreneurial Company as an Alternative to the GmbH

With a new Sec. 5a GmbHG, the government bill creates an alternative to the GmbH which is intended to carry the legal term **“(limited liability) entrepreneurial company”** *(Unternehmergesellschaft (UG) (haftungsbeschränkt)* pursuant to Sec. 5a, Subsection 1 GmbHG-RegE.

The alternative legal form of the UG as a **“small” version of the GmbH** can be formed **without adhering to the minimum share capital.** It is intended to accommodate young start-up businesses which could not be formed due to the difficulty in raising the required capital. Together with the simplified formation through the use of the specimen articles of association the new regulations will in future lead to greater simplification, flexibility and speed in the formation of a GmbH.

In deviance from Sec. 7, Subsection 2 GmbHG, which relates to the GmbH in general, however, the UG applications to the commercial register shall only be made when the share capital has been fully paid in. Contributions in kind are excluded. Since the share capital can be freely determined by the founding parties, it is not necessary to pay in only half of the share capital in order to save money. Theoretically the UG can therefore be founded with a share capital of one Euro.

However, the introduction of the UG does not constitute a general renunciation from the minimum share capital. Pursuant to Sec. 5a, Subsection 3 GmbHG-RegE **a statutory reserve must be generated** in the UG's annual statement of accounts where **1/4 of the annual surplus diminished by a loss carried forward from the previous year** must be allocated. The reserve may only be converted into share capital. In this way a higher equity base is to be achieved for the UG within a few years by means of retention.

However, the bill does not foresee a time limit for the share capital to pick up. If the minimum requirement for the share capital in Sec. 5, Subsection 1 GmbHG is achieved in the course of time, Sec. 5a GmbHG-RegE no longer applies and the company can change its name into GmbH without further steps under company law.

c) Restricting Legal Consequences of Hidden Contribution in Kind to Shareholder's Liability for Difference

While both the part of a hidden contribution in kind which pertains to the law of obligations and the in rem satisfaction of agreement were hitherto considered to be invalid along the lines of Sec. 27, Subsection 3, Sentence 1 AktG the government bill by rewording Sec. 19, Subsection 4 GmbHG and abolishing Subsection 5 GmbHG restricts the legal consequences of the hidden contribution in kind to the shareholders' liability for the difference between the actual value at the time of the company's application to the commercial register and the obligation accepted in the articles of association to make the contribution.

If the value of the hidden contribution in kind matches the amount of the accepted contribution at the time of the company's application to the commercial register and/or at the time the contribution in kind is effectively handed over to the company if this should take place later in time, the obligation to make the contribution has been entirely fulfilled. In case of a lack in full value, the difference must be made up in cash.

d) Facilitating Division and Consolidation of Shares

Pursuant to Sec. 5, Subsection 2, Sentence 2 GmbHG-RegE, a shareholder can in future receive several shares when the company is set up. Sec. 17 GmbHG would be abolished by the government bill. In future several parts of one share can thus be transferred at the same time to one acquiring party. In future the division and consolidation of shares depends only on the shareholders' consent pursuant to Sec. 46, No. 4 GmbHG-RegE.

3. Simplifying Regulations on Maintenance of Capital and Equity Replacement

The government bill foresees an eagerly awaited simplification of the regulations on the maintenance of capital and equity replacement.

a) Return to Accounting Approach and Creation of Statutory Basis for Cash-Pooling

Recent high-court decisions with respect to the maintenance of capital in a GmbH have caused significant insecurity for practical applications as to whether and how far the economically wise and widespread cash-pooling and granting of upstream loans can still be considered as legally admissible. The Federal Court of Justice *(Bundesgerichtshof – BGH)* had stated in its decisions that granting funds to shareholders to the detriment of the share capital of the GmbH and not from reserves or profit which has been carried forward must be considered as a forbidden payment of company assets even if the claim to repayment by the shareholders has full value in an individual case. The BGH came to this conclusion by abandoning the accounting approach *(bilanzielle Betrachtungsweise)*.

The government bill now clearly returns to the accounting approach. Pursuant to Sec. 30, Subsection 1 GmbHG-RegE it is not deemed a forbidden payment of company assets when a domination or profit transfer agreement has been concluded between the parties or the payment is covered by a claim to repayment or restitution by the shareholder where such claim has full value.

b) Abandoning the Legal Concept of an Equity-Replacing Loan

In future Sec. 30, Subsection 1, Sentence 3 GmbHG-RegE, determines that shareholder loans and equivalent payments should not be treated as liable equity. The legal concept of an equity-replacing shareholder loan is therefore abandoned, thereby considerably

simplifying the legal situation. The statutory regulations with respect to equity-replacing shareholder loans (Sec. 32a, Sec. 32b GmbHG) and the associated rules for high-court decisions are being rearranged within insolvency law. The rules for high-court decisions pursuant to Sec. 30 GmbHG will be abolished. The repayment of a shareholder loan can now no longer be refused by invoking an analog application of Sec. 30 GmbHG.

4. Possibility of Acquisition of Shares in Good Faith

Sec. 16, Subsection 3 GmbHG-RegE is intended to enable the future acquisition of shares in good faith. Pursuant to the government bill, the acquiring party can validly acquire a share or a right to a share from a non-entitled vendor if the non-entitled vendor is entered in the shareholder list of the commercial register as the owner of the share.

An acquisition in good faith would, of course, be inappropriate if the incorrectness of the shareholder list could not at all be attributed to a shareholder. Sec. 16, Subsection 3, Sentence 2 GmbHG-RegE thus determines that an acquisition in good faith is impossible if the shareholder list has at the time of the acquisition been incorrect for less than three years with respect to the share and the incorrectness cannot be attributed to the acquiring party. The protection of good faith only safeguards the power of disposal. Non-existent shares cannot be acquired in good faith.

5. Increased Protection Against Cases of Abuse

a) Domestic Business Address Requirement

Pursuant to Sec. 8, Subsection 4, No. 1 GmbHG-RegE, a domestic business address must in future always be stated in the application for a GmbH in order to put an end to delivery problems to the detriment of the GmbH's creditors. The business address will now be included in the commercial register. The obligation also to register alterations in the domestic business address in future shall be covered by Sec. 31 German Commercial Code *(Handelsgesetzbuch – HGB)*.

b) Avoiding Loss of GmbH Management

In the past shareholders have tried to hinder deliveries and the receipt of declarations by revoking the managing directors. An addition to Sec. 35, Subsection 1 GmbHG intends to stop this unfair practice by making each individual shareholder an alternative authorized recipient for the company should the company lose its management.

c) Extending Exclusions in Sec. 6, Subsection 2, Sentence 3, GmbHG

In order to increase creditor protection the previous obstacles of appointment in Sec. 6, Subsection 2, Sentence 3 GmbHG will be extended by the criminal offenses of delaying the filing of the petition for insolvency pursuant to Sec. 82 GmbHG; Sec. 399 AktG; Sec. 400 AktG; Sec. 331 HGB; Sec. 313 UmwG; and Sec. 17 company disclosure law *(Publizitätsgesetz – PublG)*.

A conviction leading to a prison sentence of at least one year for one or more crimes committed with intent pursuant to Sec. 265b (obtaining credit by false pretences), Sec. 266 (embezzlement) or Sec. 266a (withholding and embezzlement of salary) will in future also lead to the assumption that the managing director is generally unfit.

d) Extending Managing Director's Liability in Sec. 64, Subsection 2 GmbHG-RegE

The government bill extends the liability of GmbH managing directors to give the company's creditors more protection against assets being moved between shareholders and the company. Pursuant to Sec. 64, Subsection 2 GmbHG-RegE, managing directors should in future also be liable for payments to shareholders when such payments lead to the company becoming insolvent unless it was not possible for a prudent managing director to detect this.

e) Creating Liability for Intransparency

In practice the enforcement of possible liability claims against managing directors and shareholders is often made considerably more difficult or even impossible by completely inadequate or non-existent accounting records.

Inadequate in-house documentation means that creditors are often deliberately denied access to company assets.

The Bundesrat has therefore accommodated the request by legal experts and practical applications for managing directors and even shareholders to be liable for intransparency.

In the event of major infringements of the obligation to have in-house documentation of business processes, in particular, total lack of or severe deficiencies in the existing accounting records, the managing director who is obliged to carry out correct accounting procedures pursuant to Sec. 41 GmbHG would be liable for damages towards the creditors.

Rechtsanwalt Dr. Michael Bäumker, LL.M.

Far-Reaching Modifications in Laws on Banks and Capital Markets

In March 2007 the Bundestag passed the law to transpose the EU Markets in Financial Instruments Directive (MiFID) of the European Parliament dated April 21, 2004, into national law *(Finanzmarktrichtlinien-Umsetzungsgesetz – FRUG)*. The law will come into force as of November 1, 2007. The modifications made by FRUG in particular concern the German Securities Trading Act *(Wertpapierhandelsgesetz – WpHG)*, the German Stock Exchange Act *(Börsengesetz – BörsG)* and the German Banking Act *(Kreditwesengesetz – KWG)* as well as a variety of other laws.

The most important modifications are described below without, however, entering into the details of all the new regulations.

1. Investment advice carried out commercially was hitherto permit-free but will require a permit in future. Thus both investment brokering (brokering or documentation of transactions involving the purchase and sale of financial instruments) as well as acquisition brokering (purchase and sale of financial instruments in the name of and for the account of others) and investment advice are now only possible if the company has a corresponding permit according to the German Banking Act. The only exception when this does not apply is when the activities relate to share certificates of investment funds only. In such a case it is sufficient for the company to be registered pursuant to the law regulating trade, commerce and industry *(Gewerbeordnung – GewO)*.

Investment advice is defined as giving personal recommendations to clients with relation to dealings with certain financial instruments as far as the recommendation is based on an examination of the investor's personal circumstances or can be described as appropriate for the investor and the recommendation is not revealed exclusively via information distributing channels or is published for use by the general public.

The modification has wide-ranging consequences for investment advisors (Financial Planners, Family Offices, etc.) who were hitherto able to carry out their activities without a permit. Since it can be assumed that not all the current investment advisors will apply for a permit according to the German Banking Act, it is very likely that this business sector will become smaller.

The modification will also have an effect on already existing financial services and credit institutioins which work together with investment advisors.

2. The duties of investment services enterprises with respect to disclosure and rendering advice are specified in the WpHG where additional regulations are also included. The new regulation on the legality and disclosure of commission will in particular have practical effects. Pursuant to the new Sec. 31 d WpHG, commission is only permitted when the payment is designed to improve the quality of the service rendered for the client and the payment does not conflict with the service being rendered correctly in the client's interest. Furthermore the client must be extensively informed about the existence, type and extent of the payment.

This regulation will have an effect on the sales and marketing by financial services and credit institutions. In future the question of legality will arise in particular with regard to regular recurrent payments of portfolio commission.

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The duties of investment services enterprises regarding organization are also tightened; this concerns compliance organization, risk management, internal auditing and outsourcing of activities, for example. Furthermore, there are stricter requirements on management regarding duties to disclose conflicts of interest. The financial services and credit institutions should therefore subject their entire organization as well as agreements and other standard documentation (WpHG questionnaire, etc.) to a thorough review with respect to the new regulations.

3. The current division of statutory stock exchange trading into a Regulated Market and an Official Market will be abolished. The distinctions between the two market segments which existed in the past were largely evened out by duties of transparency and compulsory EU specifications so that the division no longer seemed appropriate to the legislators. In future, there will only be one statutory market segment. The stock exchanges are of course still at liberty to create their own quality segments (e.g. Entry Standard).

The decision to list securities shall in future be the responsibility of the stock exchange management. The stock exchange admissions offices will be abolished. Furthermore, the regulations for the lead brokers and stockbrokers will be considerably simplified.

4. The trading platforms shall in future be subject to higher transparency requirements. Trading platforms are on the one hand stock exchanges but they also include multilateral trading facilities (trading facilities which are not subject to the stock exchange rules, such as, e.g. a trading facility run by an investment firm) and internalization systems (systems where banks or brokerage houses execute in-house client orders on a regular basis). In future it will be necessary not only to publish the price, trading volume and time at which the transactions are executed (post-trade transparency) but also the current bid and offer prices as well as the depth of trading interests at these prices (pre-trade transparency). Regulations on pre-trade transparency were hitherto unknown in German Law.

Rechtsanwalt Michael Schneider

Overview of recent Legal Developments on Cross-border Mobility from a German Perspective

Across the European Union domestic company law has been given a new dimension by recent EU-Directives and various decisions of the European Court of Justice: cross-border transfers of seat as well as cross-border mergers are becoming possible. This article and the attached table are intended to provide a concise overview of the current legal developments in these areas from a German perspective.

1. Cross-Border Transfers of Seat

Decisions by the European Court of Justice made it already a few years ago possible for companies to transfer their seat to Germany if the companies were established pursuant to national law of another member state of the European Union. However, most of the prevailing opinions still agree that this does not yet mean that it is possible to transfer the seat of German companies to other European countries since the admissibility of such a outbound transfer is still a question of national (in this case German) law. The German Act to Modernize Limited Liability Company Law and to Combat Abuse *(Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen – MoMiG)* will in the beginning of 2008 allow German Limited Liability Companies *(Gesellschaft mit beschränkter Haftung – GmbH)* and German Stock Corporations *(Aktiengesellschaft – AG)* to transfer their administrative seat abroad (the registered seat as defined in the articles of association remains in Germany). Even before these changes become effective it could happen that the European Court of Justice decides in the currently pending case “Cartesio” that the national restrictions on transferring the seat out of the country are contrary to community law. In any case it will soon become possible for German GmbHs and AGs to transfer their administrative seat at least into other EU Member States.

For partnerships (e.g. *oHG and KG*) the current German principle that it is not possible to transfer the seat to another jurisdiction will probably remain applicable (no changes of the respective statutes are planed). However, new decisions by the European Court of Justice could change this legal situation, too.

It is already possible to transfer the seat of a European Company (Societas Europaea or SE) to another EU member state, whereby both the registered seat and the administrative seat can and must be transferred at the same time.

2. Cross-Border Mergers

The German law regulating the structural changes of companies *(Umwandlungsgesetz – UmwG)* includes stipulations on mergers, which applied to entirely national cases only. However, in theory cross-border mergers of companies in different member states of the European Union are already permitted under the “Sevic” decision of the European Court of Justice, at least as far as the merger of the companies concerned is allowed pursuant to their respective national law. The recent amendments of the German laws permit cross-border mergers of German GmbHs and AGs as well as SEs with seat in Germany with corporations (not partnerships) formed under the laws of other EU member states. As soon as the EU directive, which was the basis for such changes, has also been transposed in the other EU member states (which is imminent), mergers of German corporations with corporations of these member states can be performed.

For several years there has already been and will still be the (rather complex) possibility of a cross-border merger of stock corporations (public limited liability companies) for the purpose of forming a SE. A German AG, for example, can under this rule already be

merged with a stock corporation formed under the laws of another EU member state for the purpose of forming a SE.

3. Cross-Border Demergers

Cross-border demergers using companies from different EU member states are at present theoretically only permitted on basis of the "Sevic" decision of the European Court of Justice. There is currently no statutory regulation meaning that such cross-border demergers are at present unrealistic.

4. Cross-Border Conversions

Current law does not allow the possibility of converting a company in the legal form of one member state of the EU into the legal form of a company of another member state while maintaining its identity. Furthermore, the prevailing opinion does not believe that such cross-border conversions will be possible based on the current decisions by the European Court of Justice. It is possible, however, to convert an existing German Stock Corporation into a European Company with seat in Germany if the German Stock Corporation owns for at least two years a subsidiary which is subject to the law of another member state. In the opposite case a SE with seat in Germany can be converted into a German Stock Corporation if a time period of two years is observed.

Rechtsanwalt Dr. Peter C. Fischer, M.C.J. (NYU)

MEASURE	LEGAL ENTITY			
	German Commercial Partnership (oHG), German Limited Partnership (KG)	**German Limited Liability Company (GmbH)**	**German Stock Corporation (AG)**	**SE with seat in Germany**
Cross-border transfers of seat (transferring seat out of Germany)	Cross-border transfers of seat (transferring seat out of Germany)	Transfer of administrative seat will become possible in 2008	Transfer of administrative seat will become possible in 2008	Simultaneous transfer of the statutory and administrative seat is possible within the EU
Cross-border mergers	Not possible under German law; theoretically possible on the basis of the "Sevic" decision of the ECJ	Possible with other EU corporations, not with partnerships (it can be necessary to wait for the transposition of the EU directive in other member states)	Possible with other EU corporations, not with partnerships (it can be necessary to wait for the transposition of the EU directive in other member states); cross-border mergers with stock corporations from other EU states for the purpose of forming an SE are also possible	Same situation as for the AG, however, if an SE is formed, only within the SE Regulation
Cross-border demergers	Not possible under German law; theoretically possible on the basis of the "Sevic" decision of the ECJ	Not possible under German law; theoretically possible on the basis of the "Sevic" decision by the ECJ	Not possible under German law; theoretically possible on the basis of the "Sevic" decision by the ECJ	Same situation as for the AG
Cross-border conversions	Not possible under German law; according to the prevailing opinion also not permitted on the basis of "Sevic" decision of the ECJ	Not possible under German law; according to the prevailing opinion also not permitted on the basis of "Sevic" decision of the ECJ	Only a conversion into an SE with seat in Germany, or a combination of a cross-border merger and conversion for the purpose of forming an SE are possible (under certain preconditions)	Only a conversion into a German AG is possible (if a time period of two years is observed)

Liability in the Event of Erroneous Ad Hoc Announcements

I. Introduction

The question of whether the issuer is liable if the capital market is given erroneous information is still a current issue. It is constantly the subject of high-court decisions.

1. Liability on the Primary Market

Liability within the initial share offering (primary market) is regulated in special stipulations of the German Stock Exchange Act (Sec. 44 I, Sec. 45 *Börsengesetz – BörsG*) which makes the party which is responsible for the prospectus liable to the investor and compels said party to reimburse the acquisition price if the prospectus contains incorrect information and said party acted with gross negligence while such (special) stipulations are lacking for the secondary market. Sec. 44 I, Sec. 45 BörsG, also foresee a reversal of the burden of proof which is advantageous for the investor and goes to the detriment of the party which is responsible for the prospectus. Furthermore the causality forming the basis of the liability is assumed so that the investor does not need to provide evidence in a court proceeding which can sometimes be difficult to obtain.

2. Liability on the Secondary Market

Following the collapse of the *Neuer Markt* modifications for trade after the initial offering were made rather hesitantly. A liability standard for erroneous ad hoc announcements which allows claims to be made against the responsible parties, namely members of the board of management, is still lacking even today.

Although the German Fourth Financial Market Development Act *(Viertes Finanzmarktförderungsgesetz)* introduced a regulation for damages for erroneous ad hoc announcements in the summer of 2002 with Sec. 37, lit. b) and lit. c), German Securities Trading Act *(Wertpapierhandelsgesetz – WpHG)*, these standards only grant a claim against the issuing company but not against the members of their executive bodies. However, this is a disadvantage for the aggrieved investor when the company – as in the *"Infomatic"* case – becomes insolvent and the internal balancing of the damages between the company and the member of the executive body only benefits the investor indirectly since he merely receives the generally low insolvency dividend for his claim. In addition the investor has to adduce that his purchase is based on the erroneous information.

The Ministry of Finance prompted the creation of a wide-reaching regulation within the law on liability for capital market information (*Kapitalmarktinformationshaftungsgesetz – KapInHaG)* at the end of 2004. It foresaw personal liability for members of executive bodies (board of management). The investor could make claims based on gross negligence against them personally within three months following the erroneous ad hoc announcement. This provision in particular was subjected to such fierce political criticism that the law was not passed in the end. Thus the implicit causality within the respite remains only in a first draft.

Most court proceedings for damages due to erroneous ad hoc announcements of the secondary market are therefore unsuccessful (and continue to be so) because the investor simply cannot prove that he acquired the shares based on erroneous information by the issuer.

The only option in such cases of erroneous information of the secondary market is therefore to invoke the general statutory provisions in civil law, namely Sec. 826 German Civil Code *(Bürgerliches Gesetzbuch – BGB)* – intentional, immoral damnification – to make the persons who took the action personally liable and/or in turn to attribute responsibility to the

company via Sec. 31 BGB. The protection of investors which the legislation was intended to achieve and which the law on the capital market was actually supposed to guarantee thus remains debatable.

II. ComRoad

Disregarding the opposing party with respect to a claim, i.e. the personally liable member of the board of management or the company, a brief look at the latest decisions by the Federal Court of Justice *(Bundesgerichtshof – BGH)* also reveals the difficulty of proving causality.

ComRoad AG, a provider of telematics networks based in Munich, had through its chairman of the board, Bodo Schnabel, faked almost the entire annual sales figures between 1999 and 2001. Following issue of the shares the price rose to ten-fold its issue price. The fraud was blown on the deception after a special audit in 2002 and the price sank to below one Euro. The Regional Court *(Landgericht – LG)* in Munich has since sentenced the former chairman of the board to seven years' imprisonment.

Comparable cases were *"Infomatic"* and *"EM.TV"*. Here grossly incorrect ad hoc announcements provided for similar court proceedings.

With its *"ComRoad"* ruling at the beginning of June this year – ruling dated June 4, 2007 – the 2nd senate of the BGH confirmed its hitherto held position with regard to the liability of issuers, which position had already been developed in the BGH decisions in the *"Infomatic"* and *"EM.TV"* cases in 2004 and/or 2005.

The senate is of the opinion that the investor can make a claim for damages against the public limited liability company *(ComRoad AG)* based on Sec. 826 Sec. 31 BGB, because of intentional, immoral damnification due to erroneous ad hoc announcements; whereas the AG cannot invoke Sec. 57 German Stock Corporation Act *(Aktiengesetz – AktG)* – prohibition of return of contributions – and/or Sec. 71 AktG – restriction on acquiring company stock.

With respect to the defendant AG's objection regarding the principle of maintaining capital this decision confirms the position of the Higher Regional Court *(Oberlandesgericht – OLG)* in Munich, which position was also argued in 2005 by the OLG in Frankfurt (ruling dated March 17, 2005 – File No. 1 U 149/04). Both courts are of the opinion that the principle of maintaining capital pursuant to Sec. 57, Subsection 1 AktG, does not conflict with liability towards the investors.

It should be noted, however, that the BGH decision does not agree with the considerations of the previous instance, the OLG in Munich, regarding causality. These conflict with the senate's opinion because evidence of the specific causality between an erroneous ad hoc announcement and the individual decision of the investor to make the investment must also be produced for tort liability with regard to providing information if the information given to the capital market was *"diverse and extremely unreliable"*. It is therefore not sufficient *"if the securities were bought in the general excitement of the market"*.

The previous instance had confirmed the causality forming the basis of the liability with reference to the *"general course of events (…) where the chairman of the board's incorrect announcements on the defendant were able to deceive the entire interested public"* and had awarded damages to the plaintiffs.

The OLG in Munich must now conduct a retrial because further arguments by the plaintiffs were omitted due to procedural errors and the court must also look for evidence whether the plaintiffs made their decision to invest on the basis of the erroneous ad hoc announcement by the chairman of the board.

III. Conclusion

The causality forming the basis of the liability therefore remains at the center of the decision whether the plaintiff should be awarded damages or not. Such causality exists if the incorrect ad hoc announcement caused the investor to buy or sell securities. The investor must produce evidence, however, that the transaction took place on the basis of the incorrect information; the investor thus has the burden of proof.

The current *"ComRoad"* decision by the 2nd senate of the BGH assents to previous BGH decisions in the *"Infomatic"* and *"EM.TV"* cases. A serious difficulty for the investor remains the continued restrictive viewpoint of the judges to generously award the investor full damages for his stock market losses under certain circumstances while not making it any easier for the investor to produce evidence of the causality behind the transaction.

In its current *"ComRoad"* ruling the 2nd senate of the BGH rejected for German tort law the alternative recourse to the fraud-on-the-market theory which applies in the USA and which relates to the thwarted confidence of investors in the integrity of market pricing. This was what had been considered by the OLG in Munich.

It therefore remains to be seen whether the legislator will act and create special provisions on the legal elements for liability making it easier for the investor to produce evidence for causality as is the case for the primary market or whether the lines will continue to be drawn only as the law develops.

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