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German Tax and Legal News

Government draft bill of the Fourth Amendment to the German Reorganization Act: Facilitation of reorganizations involving UK legal entities

The German legislator wants to extend the possibilities for an orderly change into a German legal form available to companies affected by Brexit and extend time limits for cross-border mergers involving UK entities as transferring company. Contrary tendencies become apparent in the UK.

Government draft bill of the Fourth Amendment to the German Reorganization Act presented
On October 10, 2018, the German Federal Government presented its draft bill of the Fourth Amendment to the German Reorganization Act.

The legislative initiative strives to alleviate hardships for UK companies in the legal form of a 'private company limited by shares' and with effective place of management in Germany in connection with the transition into a German legal form, which will become necessary as a result of Brexit.

Furthermore, a transitional regime is to be created to allow the proper completion of cross-border mergers already in progress at the time of Brexit.

The draft bill shows that the German legislator – irrespective of the outcome of the Brexit negotiations – is (finally) taking care of essential issues associated with Brexit.

Accompanying tax-related provisions
The legislator is also active as regards tax consequences associated with Brexit: The draft bill presented by the Federal Ministry of Finance on October 9, 2018 (draft bill on Tax-Related Provisions Accompanying the Withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union, Brexit Tax Accompanying Act – Brexit-StBG) is intended to preserve the "status quo" in cases Brexit would trigger inappropriate legal consequences which may also be incompatible with EU law. For the taxpayer concerned, protection is to be granted for the necessary transitional period and legal certainty is to be created. In addition, the draft bill contains necessary editorial adjustments in connection with the Brexit. For further details of the Brexit-StBG, we refer to the article in Deloitte's German Tax & Legal News.

Planned introduction of generous transitional periods
In particular, the planned introduction of generous transitional periods for cross-border mergers involving companies governed by UK law as transferring company which are ongoing at the time of Brexit could be of great practical importance.

As things stand at present, it can be assumed that Brexit will result in companies from the UK no longer being eligible for participation in cross-border mergers with German companies on the basis of sections 122a et seq. of the German Reorganization Act (UmwG). This consequence will occur in a (now less probable but not excluded) no deal-scenario either immediately upon the entry into force of Brexit or with the expiry of transitional periods still to be agreed upon.

Entities contemplating to reorganize may therefore be required to complete their cross-border mergers within a short period of time, which might prove difficult or impossible due to the applicable requirements – and in particular the practical treatment in the UK, which is different from the situation in continental European legal systems.

With the new regulation through a sec. 122m UmwG to be inserted, the legislator wants to take precautions for both scenarios. Section 122m UmwG in the version of the government draft bill provides that a UK company shall continue to be regarded as an entity eligible for participation in a cross-border merger within the meaning of sections 122a et seq. UmwG for a period of up to 2 years after Brexit. The prerequisite for this is that the merger in

question is one in which a German company is involved as the acquiring company and a UK company is involved as the transferring company. Furthermore, the terms of merger must have been notarized prior to the date of the UK exit or expiry of a transitional period and the merger must have been filed for registration with the necessary merger documents with the commercial register immediately, but no later than two years after this date.

With regard to practical handling, in addition to the criticism with respect to the legislative initiative expressed by German scholars and practitioners (see below), particular attention should be paid to the fact that contrary trends can currently be discerned in the UK. A draft bill under the headline 'EXITING THE EUROPEAN UNION - COMPANIES, LIMITED LIABILITY PARTNERSHIPS, PARTNERSHIPS - The Companies, Limited Liability Partnerships and Partnerships (Amendment etc.) (EU Exit) Regulations 2018' was presented there, which provides for amendments to the Companies Act 2006 and other laws.

The object of the draft bill is, in particular, the repeal, without substitution, of the applicable statutory provisions relating to cross-border mergers with legal entities from the EEA. The Explanatory Memorandum states this quite succinct:

'Regulations that allow mergers between UK companies and companies in EEA States to take place are being revoked. After exit day, the UK will no longer have access to the regime and EEA States will no longer be required to give effect to mergers involving a UK company. On average, around fifty cross-border mergers take place under the Regulations in the UK per year. After exit day, cross-border mergers will still be able to be structured through private contractual arrangements.'

The UK legislator seems to (deliberately?) misjudge the fact that the charm of the national laws on cross-border mergers in the EEA based on the EU Merger Directive lies precisely in the accompanying harmonization of the legal requirements and that most EEA member states provide for a regime for cross-border mergers which is very similar to the system of the German Reorganization Act, but has virtually nothing in common with the 'cross-border mergers structured through private contractual arrangements' mentioned in the UK draft legislation.

If this UK draft bill actually came into force, UK companies would be barred from participating in a cross-border merger under the laws applicable to them – without the German legislature having any influence on this. Thus, actually, the envisage amendment of the German Reorganisation Act would have no impact.

Even under the current legal situation, the competent authorities in the UK tend to have difficulties with cross-border mergers; it is alleged that such operations would be deliberately delayed. Against this background, it cannot be excluded that the draft bill will be welcomed at least by parts of the UK professional public.

Further legislative developments in Germany and the UK remain to be seen. Until the relevant laws come into force – the enactment of which cannot be assessed – it is to be assumed that a merger of UK companies in accordance with sections 122a et seq. UmwG will no longer be possible once the UK exit takes effect, at the latest with the expiry of any transitional periods that may still be provided for.

Facilitating cross-border mergers with Limiteds

Impending personal liability for the company's debts after Brexit

Based on the jurisprudence of the European Court Justice with respect to the freedom of establishment, companies duly incorporated under UK law are recognized in Germany as such, even though their effective place of management is actually in Germany. In the past, numerous founders made use of the possibilities arising from this legal situation. As a result, about 8,000 - 10,000 of these companies still exist in Germany according to estimates of the Federal Government.

Brexit, which is expected to happen on March 29, 2019, presents these companies with new challenges. Once the UK has left the European Union and applicable transitional periods (if any) have expired, they can no longer invoke the freedom of establishment and therefore lose their status as limited liability companies in Germany. In any case, this entails personal liability at the level of the founders/shareholders for the debts of their companies, which cease to be recognized as such from a German legal perspective.

No appropriate solution for the problem under the current legal situation

Ways of transferring the business of affected entities to domestic legal forms providing limited liability are already in place de lege lata. In particular, the cross-border merger into a

Limited Liability Company (Gesellschaft mit beschränkter Haftung – GmbH) or a Stock Corporation (Aktiengesellschaft – AG) can be mentioned in this regard. However, the options available can come along with significant financial, organisational, tax and purely practical disadvantages.

Remedy by means of amendments to the German Reorganization Act

Against this background, the legislator assumes that the current legal situation does not meet the needs of the companies concerned, which are often rather capital-weak legal entities. The purpose of the draft is to remedy this situation.

In concrete terms, domestic commercial partnerships, which normally do not employ more than 500 employees, will also be able to participate in the cross-border merger as acquiring or new legal entities. It is contemplated to amend especially sec. 122b para. 1 UmwG accordingly, which under the current legal situation only permits corporations as participants in a cross-border merger.

The draft bill provides affected founders with additional options for converting their company into a domestic legal form. According to the official justification for the draft bill, the Federal Government particularly has the merger into a Limited Partnership (*Kommanditgesellschaft – KG*) in mind, in which a GmbH or an Entrepreneurial Company (*Unternehmergesellschaft – UG*) could participate as general partner. As a result, a limitation of liability would be ensured; in the case of the participation of an UG, even without the necessity of raising a share capital of at least EUR 25,000 pursuant to sec. 5 para. 1 of the German Limited Liability Companies Act (GmbHG).

Draft bill to be welcomed in principle
In principle, the objective of the draft bill to remove the legal uncertainties created by Brexit and to offer pragmatic solutions is to be welcomed.

It should be noted, however, that the initiative is viewed quite controversially from a legal policy stand point. In view of the fact that German law already provides legally secure solutions to the problem, albeit possibly cost-intensive ones, the question is often asked as to whether the proposed amendments are necessary and appropriate. In its very critical statement on the draft bill, the German Association of Notaries (Deutscher Notarverein) takes the view that the hardships existing under the current legal situation are a "just consequence" of having evaded the German legal system "for reasons not worth protecting" when the company was founded. It is rather questionable whether this view shall be followed, especially as the founders have only made use of their fundamental freedoms.

In addition, the planned transitional 2-years period is criticised with the argument that the UK companies concerned have already had enough time since the referendum to prepare for the withdrawal from the European Union. However, this argument fails to recognise that it is still unclear whether and in what form Brexit will actually come. Should companies really be burdened with the imponderables and risks arising from an unclear political and European/public international law situation?

Outlook
According to the current plans of the German legislator, the Fourth Amendment to the German Reorganization Act is to enter into force on January 1, 2019. Whether and to what extent it will actually come into effect cannot be conclusively assessed yet. The further developments therefore remain to be seen. The same applies to the legislative developments in the UK. Here, too, it is not yet possible to assess whether the draft bill outlined above, which would entail the repeal of all provisions relating to cross-border mergers, will actually take effect in this form.

Until binding regulations come into force, entrepreneurs will unfortunately have to face legal uncertainty and the recommended course of action (in particular for UK Limiteds with effective place of management in Germany) can only be to take further precautions now and not to trust that legislators will act in good time.

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