

On the Subject

Update from Germany

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Election Campaigns Focus on Tax Reform

The campaign for the election on September 18 in Germany is underway and tax reform is on the agenda of each of the major political parties. The following summarizes, from an international investor's perspective, key aspects of the proposed tax reforms from the party platforms of the Christian Democratic Union and the Christian Social Union (CDU/CSU), headed by Angela Merkel, and the Social Democratic Party (SPD), the party of Chancellor Schröder. Current polls indicate that Mrs. Merkel may become Germany's first female Chancellor.

The CDU/CSU proposes to cut the corporate tax rate from 25 percent to 22 percent, lowering the tax burden for inbound investments to approximately 35 percent (depending on the trade tax rate). If elected, the party would lower the basic income tax rate from 15 to 12 percent and the marginal rate from 42 to 39 percent. However, this tax cut would be refinanced by closing "tax loopholes" and reducing the tax benefits of special funds, such as media funds. Further, the value-added tax, or VAT, rate would be raised from 16 to 18 percent. The most significant reform for investors would be the abolishment or reduction as of January 1, 2006 of the 95 percent corporate tax exemption for capital gains derived from the disposal of shares. Under this proposal, M&A transactions will need to be closed before the end of 2005 to receive the current exemption.

SPD proposes to cut the corporate tax rate from 25 percent to 19 percent. The drop in the corporate tax rate would be refinanced entirely by revenues gained from tightening tax rules and

reducing tax benefits derived from certain fund investments, quite similar to the proposal of CDU/CSU. For example, the minimum taxation might be increased. Currently 40 percent of the profits exceeding €1 million must be taxed (income, corporate and trade tax). An existing loss-carry-forward cannot be deducted from this amount. The SPD plans to increase this rate to 50 percent of the profits exceeding €1 million. The SPD also proposes to raise the current flat-rate trade tax credit for income tax purposes. A three percent extra tax on income above €250,000 a year (a "tax on the rich") is planned by SPD as well.

The tax reform proposals in the party platforms are only an expression of potential reforms considered feasible if the party is successful in the election. More radical reforms such as a uniform taxation of business entities regardless of their legal form is merely mentioned by both parties in general terms. Nonetheless, regardless of who wins the election, it is expected that there will continue to be pressure on Germany's leaders to further overhaul the country's tax laws beyond what the major parties have specifically proposed to date.

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Significant Changes to German Antitrust Law

Under recent amendments to Germany's national antitrust laws, companies active in Germany will not need to obtain a positive clearance from the German cartel authorities to pursue a business combination transaction. This new self-responsibility and lack of legal certainty, however, will increase the risk that, in the event of infringement of the Act Against Restraints of Competition (ARC, *Gesetz gegen Wettbewerbsbeschränkungen*), companies will be fined or subject to claims for damages by competitors.

Since July 1, 2005 companies active in Germany have to follow the amended rules in ARC. Modernizing ARC brought Germany's national antitrust law in line with that of Europe so the Federal Cartel Office (FCO, known as the *Bundeskartellamt*) can apply European antitrust rules appropriately. Even though

German antitrust law will still be applicable for local cases, the adoption of changes to the ARC has moved German antitrust legislation closer to the European antitrust rules. Global companies with operations in Germany should become familiar with the following changes.

Cartel Regulation: No Duty for Filing and Clearance Decisions but a Directly Applicable Exception System

Germany has adopted the new European antitrust law system based on Regulation (EC) 1/2003 (effective May 1, 2004). As of July 1, 2005 Germany operates under a directly applicable exception system in which the FCO and the German courts have the power to apply article 81 (3) of the EC Treaty and the so-called “block exemptions,” which set out the terms of “safe harbors,” even though only national markets are affected. Consequently, the special exemption rules (*e.g.*, agreements on standards and types, specialization or rationalization agreements) and the notification procedure rules were disposed of; however, a special exemption for co-operations of medium-sized business remains (section 3 of the ARC).

Vertical Restraints: No Differentiation between Horizontal and Vertical Agreements

Formerly, ARC did not provide for a general prohibition of all restrictive agreements but rather distinguished between horizontal and vertical agreements. Only horizontal restraints were prohibited while vertical restraints were acceptable (except for the fixing of resale prices and commercial agreements leading to the same effect).

The new ARC does not differentiate between horizontal and vertical restraints, but it does bring vertical restraints under the general prohibition of restraints of competition (section 1 of the ARC). As of July 1, 2005 vertical restraints are prohibited, not as before with a regulatory watchdog system but with a directly applicable exception system according to the European rules, *i.e.*, vertical agreements with restraints of competition will be allowed up to a market share of 30 percent of the relevant market except for so-called “hardcore restrictions,” such as price fixing and territorial allocation. Germany will retain, however, its special price-fixing exemption for newspapers, magazines and books (section 30 of the ARC).

Increased Enforcement Powers and Fines

The fine for serious offenses will now be up to €1 million for individuals and up to 10 percent of the total revenue in the preceding business year for companies. The changes mean that businesses will need to be particularly vigilant in assessing the lawfulness of their commercial activities.

The FCO will have the power to launch sector inquiries into particular economic sectors if circumstances suggest that, in the

economic sector concerned, competition is being restricted or distorted within the German market.

Private Enforcement

The new ARC contains a number of changes intended to facilitate claims for damages based on infringements of antitrust law. This includes the relaxation of the “protective purpose” requirement in German law, which the courts have interpreted as limiting the circle of potential claimants to those directly targeted by the infringer, a requirement which has proved very difficult to meet in practice.

Under the new rules, price fixers will no longer be able to rely on the so-called “passing-on-defense.” In most cases it is ultimately the consumer who pays for price fixing. As a consequence, the complainant (if price fixing was directly aimed at him) has a formal claim against the price fixer without having suffered any damages since he passed on the higher prices to his customers, and the customer suffers damages but has no formal claim since the price fixing was not directly aimed at him.

In place of indemnity, the new rules will ensure that the complainant will forgo all advantages stemming from anti-competitive practices.

Merger Control

As the new European regulation only affects the enforcement of articles 81 and 82 of the EC Treaty, there remains a discrepancy between the European merger control regulation (No. 139/2004) and German merger control laws. As a result, German merger control rules were not changed. Therefore, a transaction remains within the scope of German jurisdiction if it only affects the German market and certain revenue thresholds are met (without reaching the level of EC merger control). In addition, special rules for the control of press and media were planned but not realized due to unresolved disputes between the political parties. The possibility of obtaining an extraordinary ministerial authorization in the face of causing a restriction of competition was maintained.

Conclusion

As noted, the new system provides companies active in Germany with more freedom, flexibility and less bureaucracy. Although companies’ interests have been taken into account to some extent by including a provision allowing the possibility of negative clearances for a transitional period of four years, they will have to watch their actions closely when entering into agreements or engaging in other business practices that may infringe German antitrust laws.

In addition, chief executives may be held personally liable for the breach of the ARC. Therefore, it is clear that the German cartel authorities will expect companies and their executives to put in

place a stronger internal legal antitrust audit than before. However, competitors may be less inclined to limit themselves to filing complaints with the FCO as they did in the past and more likely to file actions claiming damages (private enforcement). In short, the seventh amendment of ARC provides companies with more freedom but also with more responsibility and requires increased awareness of antitrust matters.

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Proposed Law Would Require Public Companies to Disclose Individual Management Salaries

Senior management of publicly owned companies in Germany would be required to reveal their salaries under a draft bill proposed by the Federal Government. The measure, which has sparked controversy in a country that agonizes over pay gaps between management and staff, “would bring German rules into line with those in the United States and elsewhere,” said German Justice Minister Brigitte Zypries. Many companies oppose the new rules and argue they should be allowed to decide for themselves whether to make their individual executives’ pay a matter of public record. The Federal Government intends to pass the legislation in the parliament by the end of 2005. The largest opposition party (CDU) has announced its support for the new rules.

Under the proposed law, the management board of stock corporations would be required to reveal the names and the individual salaries of its board members and to include an itemization of the benefits into performance-based and fixed components as well as other incentive compensation (e.g., stock options) according to the recommendations of the Corporate Government Codex. Further, the disclosure requirements would include benefits payable if a board member’s employment is terminated. For this reason, pensions and redundancy payments would have to be included because they often reflect the main part of the total benefits. The required information would be attached regularly to the annual accounts and group accounts. Listed stock corporations would be required to indicate the management board’s salary and benefit structure in the management report.

Shareholders may allow a company to opt out of disclosure of individual management board compensation. The requirement for non-disclosure is approval of a resolution to that effect by at least a three-quarter majority at the annual general meeting. Such a resolution would be effective for a maximum of five years, after which a renewal of shareholder approval of the opt-out would be

required. If a company opts out of individualized disclosure, management income per business year would still have to be disclosed in the aggregate with regard to each of salaries, profit sharing, rights issues, expenses, premiums or other benefits.

The Federal Government has stated that the disclosure of the individual income and benefits of board members will enable shareholders to judge the quality of the decisions of the supervisory board with regard to management salaries and benefits and their relation to individual and company performance. Shareholder advocates have hailed the draft legislation as an important victory in the fight to tighten corporate governance guidelines.

A number of industry leaders have criticized the law, arguing investors would gain little insight from the disclosure of individual manager’s pay deals. Penalties for infringers are fairly low; companies that refuse to reveal both the fixed and performance-based pay of their managers proposed fines will not exceed €50,000 per board member. The legislation is expected to go into effect in time for the 2006 business year, so individual management income and benefits can be published with the 2006 annual reports.

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New Law Affects Potential Civil Liability of Directors for Wrongful Business Decisions

The new German Law on Corporate Integrity and Modernization of Shareholder Law Suits (UMAG) significantly amends the German Stock Corporation Act (AktG, or *Aktiengesetz*.) with regard to potential liability of directors.

A directors and officers (D&O) insurance policy can help but not entirely exclude the risk to a director (who has the burden of proving she acted responsibly and in accordance with the law) of incurring unlimited damages.

The amendments to the German Stock Corporation Act, which become effective November 1, 2005, include:

- The UMAG incorporates the American “business judgment rule” into the AktG. A director is not liable for wrong business decisions if he does not have a personal interest in the subject of the decision and if he rationally believes he is making an informed decision in the best interest of the company. Most likely the courts will apply this standard to directors of limited liability companies.

- Under section 147 of AktG, shareholders holding a one percent nominal stake in a stock corporation or who own listed shares with a market value of at least €100,000 will be entitled to claim damages from the corporation's directors.
- Shareholder lawsuits against directors of stock corporations will be filtered and concentrated through preliminary court proceedings that must allow shareholder litigation. The responsible court will allow claims for damages only if (i) the claiming shareholders held their shares prior to the alleged wrongdoing of the director, (ii) the shareholders urged the company without success to litigate the matter on its own behalf, (iii) they allege facts that would prove gross negligence of the director and (iv) there are no important reasons which would justify the inadmissibility of shareholder law suits.

In order to reduce personal risk, directors should comply with the following:

- If there is a conflict of interest because a director intends to act also in his own interest, the director should delegate the decision to disinterested parties. If this is not possible, the conflict of interest should be disclosed to the supervisory board or at the shareholders' meeting.
- Because directors have to prove they acted in accordance with statutory law and the bylaws, they should ensure that evidence of their actions are well preserved by keeping records and confirming the minutes of board meetings correctly reflect the board's discussions.
- Finally, obtaining external advice from professional experts is beneficial because it indicates the directors did everything possible to make an informed decision.

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McDermott Will & Emery News from Germany

McDermott Will & Emery has been nominated as law firm of the year for tax and telecommunications, media and technology by the JUVE directory. JUVE, the publisher of the popular monthly *JUVE Magazine*, covers the German legal market and produces the leading legal directory in the country. Category winners will be announced in October.

McDermott has also recently expanded its tax practice in Germany. The Munich-based tax team comprising German lawyers (RA) and tax consultants (StB) will be strengthened by the substantial knowledge and practice experience of Dr. Joachim M. Giehl, Oliver Kächele and Markus Roth. Dr. Ralf Eckert

founded our German tax practice in 2002 and welcomed Prof. Dr. Arndt Raupach, Dr. Dirk Pohl and Prof. Rüdiger von Groll in 2004. The new team is particularly rated for its ability to advise on open and closed funds as well as on M&A and private equity.



Dr. Joachim M. Giehl, a German lawyer and tax adviser (StB), also advises banks and insurance companies on all legal, tax and accounting matters. Oliver Kächele, a German auditor and tax adviser, is a recognized expert in the media and property industry and has advised mainly on national and international closed funds for private and institutional investors. The focus of Markus Roth's advice has been on national and international M&A transactions, particularly private equity and structured finance.

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