German Corporate Law 2021 – A New Dawn beyond Covid-19, Protectionist Tendencies and the Wirecard Fall-Out

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The following overview summarizes a selection of corporate law changes either recently introduced or in the pipeline for 2021 which we would consider of interest for the transactional business in Germany and the M&A market at large.

While corporate law is rarely at the forefront of addressing economic upheaval or unprecedented social change, the impact of the Covid-19 pandemic has also triggered a flurry of legislative changes to the German corporate landscape in 2020.

Some of these changes will directly affect M&A activity and how transactions are structured in the future: This is certainly true for the successive recent reforms of German foreign investment laws briefly described in section 1 below.

The impact of certain other headline changes in the corporate law arena in the year 2020 are more reflective of general socio-economic trends in Germany, meaning their impact on the transaction business will be felt less keenly and rather more by indirect reflex. Examples of the legislator's response to such broader societal trends include the proposed extension of gender quota for German corporate boards (section 4) or a further tightening of the grip of German corporate governance rules on the independence and interaction of internal and external supervisory functions in reaction to the widely-publicized Wirecard scandal (section 3) that proved to be one of Germany's biggest stories in 2020 away from the spotlight of the Corona pandemic.

We round off our overview of key corporate reforms with a summary in section 2 of a number of important organizational corporate simplifications enacted in direct response to the pandemic and a feature on the taxation of the compensation received by supervisory board members that investors into public companies ought to be aware of (section 5).

1. German Foreign Direct Investment Control – Rule-Tightening in Light of Covid-19 and the EU Screening Regulation

In December 2020, for the very first time, the German Federal government officially prohibited the acquisition of a German company under the rules of foreign investment law, namely the indirect acquisition of a German company with specific expertise in satellite/radar communications and 5G millimeter wave technology by a Chinese state-owned defense group. The decision is the culmination of an eventful year which has seen various changes to the rules on foreign direct investments (the "FDIs") in light of, inter alia, Covid-19 and the application of the EU Screening Regulation.[1]

Below is an overview of the five key changes that have become effective over the course of 2020:

(1) Extension of the catalog of select industries triggering a mandatory filing with the German Ministry of Economy and Energy (*Bundesministerium für Wirtschaft und Energie, BMWi)* upon acquisition of 10% or more of the voting rights in a German company by a non-EU/non-EFTA acquirer to include (i) personal protective equipment, (ii) pharmaceuticals that are essential for safeguarding the provision of healthcare to the population as well as (iii) medical products and in-vitro-diagnostics used in connection with life-threatening and highly contagious infectious diseases.

(2) No more gun-jumping: All transactions falling under the cross-sector review that require a mandatory notification (*i.e.*, FDIs of 10% or more of the voting rights by a non-EU/non-EFTA investor in companies active in one or more of the conclusively listed select industries) may only be consummated upon conclusion of the screening process (condition precedent).

1 EU Regulation (EU) 2019/452 of March 19, 2019 establishing a framework for screening of foreign direct investments into the EU, available in the English language version under: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0452&from=EN.

(3) Introduction of penalties (up to five years imprisonment or criminal fine (in case of willful infringements and attempted infringements) or an administrative fine of up to EUR 500,000 (in case of negligence)) for certain actions pending (deemed) clearance by the BMWi, namely: (i) enabling the investor to, directly or indirectly, exercise voting rights, (ii) granting the investor dividends or any economic equivalent, or (iii) providing or otherwise disclosing to the investor certain security-relevant information on the German target company (particularly relevant for the due diligence process in M&A transactions). In addition, non-compliance with enforceable restrictive measures (*vollziehbare Anordnungen*) imposed by the BMWi is no longer only punishable as an administrative offense, but, in case of willful (or attempted) infringements, also as a criminal offense with up to five years imprisonment or criminal fine.

(4) Implementation of the EU-wide cooperation mechanism as required under the EU Screening Regulation.

(5) Expansion of the grounds for screening under German FDI rules to include public order or security (*öffentliche Ordnung oder Sicherheit*) of a fellow EU member state as well as effects on projects or programs of EU interest, and tightening of the standard under which an FDI may be prohibited or restrictive measures may be imposed from "endangering" (*Gefährdung*) to "likely to affecting" (*voraussichtliche Beeinträchtigung*) the public order or security, so as to reflect the EU Screening Regulation.

For additional details on these and other changes in 2020 to foreign investment control and an overview on the overall screening process in Germany, please refer to the respective brief summaries published by Gibson Dunn Germany in May 2020[2] and November 2020[3].

The impact which such changes to the regulatory framework on foreign investment can have on the transactional business is clear to see. Undoubtedly, the pandemic has initiated a worldwide trend towards protectionism that may ultimately hamper inbound investment. But even if such restrictive worst case scenarios are discounted, the accelerating speed and cadence of reform, at a minimum, creates a degree of uncertainty in the M&A market, even more so as further changes to the German Foreign Trade and Payments Ordinance (*Außenwirtschaftsverordnung*, *AWV*) are already announced for 2021. In particular, the catalog of critical industries are to be extended further: Based on earlier announcements by the BMWi, artificial intelligence, robotics, semiconductors, biotechnology and quantum technology will likely be added to the catalog of critical industries.

Due to these continuing reform activities of the German legislator, the analysis whether advance clearance by the BMWi is required (or whether, at least, a certificate of non-objection should be obtained) becomes increasingly tricky and needs to be factored into a transaction timeline. Foreign investment rules may thus take on less of a niche existence in the medium term and dealing with them e.g. by way of a closing condition for (deemed) FDI clearance will likely become an integral part of the transactional tool-kit similar to anti-trust clearance.

2. Next Round – Virtual-only Shareholders' Meetings of Stock Corporations in 2021

The temporary Covid-19-related legislation of March 2020 allowing to hold virtual-only shareholders' meetings of stock corporations in 2020[4] has been extended until the end of 2021 by means of an executive order of the German Ministry of Justice and Consumer Protection (*Bundesministerium der Justiz und für Verbraucherschutz*) issued in October 2020. While the legal framework of the temporary regime for virtual-only meetings remained unchanged, the regulator strongly appealed to the management of the relevant corporations to use the emergency instrument of a virtual-only meeting in a responsible manner, taking into account the specific individual circumstances due to the pandemic situation.

In addition to this mere moral appeal by the executive branch, just before year-end and somewhat surprisingly, the parliamentary legislator modified the March 2020 legislation with regard to the shareholders' right to information in virtual-only meetings as a concession to the widespread criticism in the aftermath of the March 2020 legislation. The March 2020 legislation had reduced the shareholders' right to information to a mere possibility to submit questions in electronic form prior to the meeting, leaving it up to management in its sole discretion as to whether and in which manner to answer such questions. Additionally, it allowed management to set a submission deadline of up to two days prior to the meeting. The October legislation, addressing widespread criticism raised not only by shareholder activists and institutional investors but also by legal scholars, restored the shareholders' right to ask questions in the 2021 season for shareholders' meetings taking place after February 28, 2021: It will again constitute a genuine information right requiring management to duly answer all shareholders' questions submit-

2 "German Foreign Investment Control Tightens Further", available under https://www.gibsondunn.com/german-foreign-investment-control-tightens-further/.

3 "Update on German Foreign Investment Control: New EU Cooperation Mechanism & Overview of Recent Changes", available under https://www.gibsondunn.com/update-on-german-foreign-investment-control-new-eu-cooperation-mechanism-and-overview-of-recent-changes/.

4 Also see the corresponding earlier updates by Gibson Dunn Germany published on March 27, 2020, section III., available under https://www.gibsondunn.com/whatever-it-takes-german-parliament-passes-far-reaching-legal-measures-in-response-to-the-covid-19-pandemic/ and on September 24, 2020, available under https://www.gibsondunn.com/covid-19-german-rules-on-possibility-to-hold-virtual-shareholders-meetings-likely-to-be-extended-until-end-of-2021/.

ted in time prior to the meeting. In addition, the cut-off deadline for the submission of shareholders' questions may not exceed one day.

Furthermore, the parliamentary legislator also clarified in its last minute amendments that counter-motions by shareholders that are submitted for publication with the company at least 14 days prior to the shareholders' meeting must be dealt with in the virtual-only shareholders' meeting if the submitting shareholder has duly registered for the virtual shareholders' meeting.

The virtual-only format is available to shareholders' meetings of stock corporations which are held by December 31, 2021. In light of the current pandemic, the extensive use of the virtual-only format and the frequently observed extraordinary high participation-rate of shareholders in 2020, it can be expected that most stock corporations will again hold their shareholders' meetings in a virtual-only format in 2021.

In a similar vein, the Covid-19 Pandemic Mitigation Act (*Gesetz zur Abmilderung der Folgen der Covid-19-Pandemie im Zivil-, Insolvenz- und Strafverfahrensrecht)* provided for, *inter alia·* (i) a modification of the Limited Liability Company Act (*GmbHG*), which facilitates shareholder resolutions in text form or by written vote (circulation procedure) without requiring the consent of all shareholders to such procedure, and (ii) a modification of the Conversion Act (*UmwG*) with regard to measures requiring the submission of a closing balance sheet, where the balance sheet reference date (*Bilanzstichtag*) used in such filings can now be up to twelve months old at the time of the register filing instead of a maximum of eight months as under the regular statutory rules.

Both of these Covid-19-induced rules were extended by legislative decree dated October 20, 2020 (*Verordnung zur Verlängerung von Maßnahmen im Gesellschafts-, Genossenschafts-, Vereins- und Stiftungsrecht zur Bekämpfung der Bekämpfung der Auswirkungen der Covid-19-Pandemie)* until December 31, 2021.

While these changes are purely corporate rather than transactional at first sight, in particular, the ability to use year-end financial statements for the full calendar year rather than just the first eight months like previously, does offer additional leeway for investors when entering the post-closing restructuring phase that often follows a successful acquisition.

3. Legislative Initiative to Strengthen Market Integrity after the Wirecard Scandal

In the aftermath of the spectacular collapse of German payment solutions provider Wirecard in the summer of 2020, the German Government on December 16, 2020 presented a draft bill (*Regierungsentwurf*) for an Act on the Strengthening of the Financial Market Integrity (*Finanzmarktintegritätsstärkungsgesetz*; *FISG*) which aims to restore and strengthen trust in the German financial market.

The draft bill provides for new rules designed to bolster both the internal (in particular, via the supervisory board) and external (e.g. by strengthening the independence of external auditors and their supervision) corporate governance of companies of public interest, including listed companies.

This includes, in particular, the explicit obligation for the management board of a listed stock corporation to implement an adequate and effective internal control and risk management system. Furthermore, the draft bill also aims to strengthen the accounting and audit expertise present in the supervisory board of listed companies: Whereas the law currently only requires that, at least, one supervisory board member shall have expertise in the fields of accounting and auditing, the draft bill requires that, at least, one board member has expertise in the field of accounting and, at least, one other board member has expertise in the field of auditing, thus increasing the minimum number of experts to, at least, two board members. In addition, the establishment of an audit committee by the supervisory board shall no longer be discretionary but becomes compulsory for companies of public interest, including all listed companies.

In order to strengthen the independence of the auditor as part of a company's external safeguards, the draft bill suggests the tightening of the mandatory external rotation. The external rotation of the auditor shall occur no later than after ten years for all companies of public interest, including listed companies, thus eliminating national exemptions from the EU audit regime, which currently allow for a maximum term of 24 years, and introduces further restrictions on non-audit services that can be provided by the auditor.

In reaction to the widespread criticism leveled at the response of Germany's Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht, BaFin*) to the events that led to Wirecard's collapse and the perceived failure of the supervisory and enforcement procedures and mechanisms in financial reporting, the draft bill also proposes revisions to the current supervisory and enforcement procedures, including further-reaching competences for the financial regulator *BaFin* itself.

Last but not least, the draft bill provides for increased civil liability for damages caused by auditors as well as a tightening of criminal and administrative penalties for misrepresentations made by company representatives and statutory auditors in connection with the preparation and audit of company accounts.

The Government's draft bill essentially corresponds to a joint ministerial draft of October 26, 2020 by the Federal Ministry of Finance (*Bundesministerium für Finanzen*) and the Federal Ministry of Justice and Consumer Protection (*Bundesministerium der Justiz und für Verbraucherschutz*), which had been met with widespread criticism arguing that the proposals were not going far enough and failed to address the shortcomings of the current system which were also identified by the EU's securities market regulator, the European Securities and Markets Authority (*ESMA*), in its special report on the Wirecard collapse published in November 2020. It remains to be seen whether and to which extent this criticism will be taken up by the lawmaker in the upcoming parliamentary process by providing for more fundamental changes and reforms.

For the time being, this mooted reform mainly seems to be one for the watch-list for investors, rather than fraught with immediate red flags or to-dos for the M&A market. It is, however, indicative of a clear trend towards tighter regulation in Germany – a trend also replicated, for instance, in tighter money-laundering rules – which investment professionals will do well to factor into their strategic long-term planning.

4. Gender Quota for (Certain) Management Boards on the Horizon

Five years after the (first) Management Position Act (*Führungspositionen-Gesetz*) for the first time implemented a mandatory female quota for the composition of supervisory boards of certain German companies in 2016,[5] the German government coalition parties now support a mandatory quota also for management boards. In the future, under the contemplated Second Management Position Act (*Zweites Führungspositionen-Gesetz*) (i) listed companies, (ii) which are subject to the 50% employee co-determination under the Co-Determination Act (*Mitbestimmungsgesetz*) and (iii) whose management board consists of more than three members, must appoint at least one female management board member whenever a position becomes vacant.

The new management board quota will only apply with regard to the rather limited number of companies which meet all of the above criteria. However, it is nevertheless a strong signal by the German coalition parties to a German business community in which voluntary commitments to increase gender equality have failed to gain significant momentum in the past. Under the 2015 Management Position Act which had introduced the mandatory gender quota for supervisory boards, companies were in addition requested to set themselves gender targets for the composition of their management boards. Rather than taking the opportunity to consider voluntary targets in line with the specific circumstances of a company, a large number of affected companies simply set the target at "zero" year after year. By contrast, the mandatory 30% gender quota for the composition of supervisory boards has not just been met but even exceeded and is currently polling at approximately 37%.

For all companies in which governmental authorities hold a majority, the contemplated Second Management Position Act will also (i) provide for a mandatory 30% female quota for the composition of supervisory boards and (ii) introduce a minimum number of mandatory female management board members. In addition, public law corporations (*Körperschaften des öffentlichen Rechts*) primarily active in the health and insurance sectors which typically employ a large number of female staff, will be required to appoint at least one female board member if the board is composed of two or more members.

The draft legislation was approved by the cabinet in early January 2021 and will now be submitted to the German Parliament. The new gender quota should in any event come into force prior to the German federal elections in autumn 2021.

While a number of corporations welcome the move towards more gender equality as Germany is lagging behind in comparison to, in particular, Scandinavian and UK companies, others oppose the quota law arguing undue interference with the right of the supervisory board to appoint the best available candidate. It will be interesting to see if and how investors position themselves. This will, in particular, be fascinating to observe when it comes to foreign investment or M&A activity driven by US or UK private equity players that hail from countries where the cultural significance of strong diversity has long been established and is widely recognized also as a driver of or sign-post for economic success.

5. New Developments on Taxation of Remuneration for Supervisory Board Members

As a consequence of a ruling by the German Federal Fiscal Court (*Bundesfinanzhof*, *BFH*) late in 2019, the tax classification of compensation paid to supervisory board members has been modified in terms of value-added tax (VAT). In order to avoid potential adverse tax effects based on the incorrect tax treatment of supervisory board compensation, both individual supervisory board members and the companies they serve should be familiar with the ruling.

Previously, the tax authorities presumed without further differentiation between fixed or variable supervisory board compensation that members of supervisory ▸▸

5 In this context, see section 1.6 of Gibson Dunn's 2015 Year End Alert available under https://www.gibsondunn.com/2015-year-end-german-law-update/.

boards were engaged in independent entrepreneurial activity and their remuneration was to be charged with VAT. It was irrelevant whether the respective member of the supervisory board was an elected member, served on the board as a shareholder delegate or in a capacity as an employee representative. At least in those cases where supervisory board members receive a fixed compensation for their service, future invoices will no longer be permitted to charge a VAT component.

The respective ruling by the *BFH* applied an earlier decision of the European Court of Justice (*ECJ*) taken on June 13, 2019 at the national level and confirmed the ECJ's view that supervisory board members who receive fixed remuneration are not qualified as independent. The ECJ held in its decision that supervisory board members, who act on behalf of and in the sphere of responsibility of the supervisory board, do not bear any economic risk for their activities and therefore do not perform entrepreneurial activities due to a lack of independence. The *BFH* followed the argumentation of the ECJ and agreed that supervisory board members who receive a fixed remuneration which is neither dependent on their attendance at meetings nor on the services actually performed, cannot be classified as entrepreneurs. The *BFH* left it open whether independent entrepreneurial activities can be deemed to exist in cases where a variable remuneration is agreed with the individual member of the supervisory board.

For the individual supervisory board member, such classification as a dependent activity means, at least, in the case of fixed remuneration, that he or she may no longer add a VAT element to the remuneration in invoices issued to the company. Otherwise the supervisory board member would owe such tax, while the company would not be able to deduct such an incorrectly added tax component as an input tax deductible. Likewise, input tax amounts incurred in connection with the activity as a supervisory board member (e.g. VAT on travel expenses or office supplies) would no longer be recoverable due to the lack of independence of the supervisory board member.

If the supervised company is entitled to an unrestricted input tax deduction, this new jurisprudence should not have any adverse economic impact on the company, provided correct invoices are issued. Industries which are not entitled to deduct input tax or only entitled to deduct it to a limited extent - such as banks, insurance companies or non-profit organizations – actually benefit if the supervisory board member issues invoices without VAT.

The tax authorities have so far not yet published any guidelines in response to the new case law. It therefore remains to be seen whether the tax authorities will draw a distinction between fixed and variable compensation when qualifying the activities of a supervisory board member for VAT purposes. It would also be conceivable that the tax authorities would now generally assume that a supervisory board member's services are deemed to be a dependent activity which is generally not subject to VAT.

However, since a short-term response to the case in the administrative guidelines is to be expected in the near future, the ruling should be applied to fixed compensation and VAT should not be included in any future invoice. In the case of variable compensation and in view of the previous administrative practice, the invoicing of a separate VAT component would continue to be required until the tax authorities have communicated their new position on the matter or – if variable compensation is also to be accounted for without VAT – legal action may become necessary. It also remains to be seen whether the tax authorities will apply the new case law retrospectively and whether and how it would take into account considerations of the protection of legitimate expectations (*Vertrauensschutz*). ■

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