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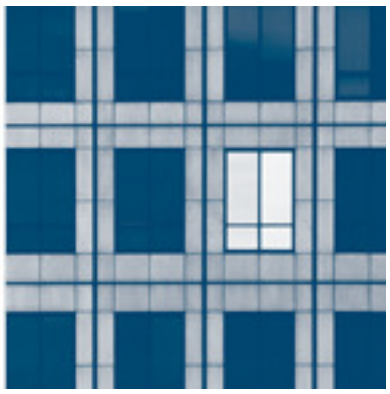
On the Subject



Update from Germany

February 2008

In This Issue

Taxation of Stock Options Granted to Expats

The secondment of employees from U.S. parent companies to German subsidiaries or branches is a well-established tool to enhance cooperation between the offices and promote the exchange of knowledge, experience and cultural understanding. However, the tax issues raised by secondment must be considered carefully. At the level of the parent organization, the formation of a permanent establishment should be avoided. The costs related to the expatriate employees' functions must be allocated for tax purposes between parent and subsidiary, and this allocation is a crucial issue often challenged by fiscal authorities. The expatriate often receives an attractive package including a top executive compensation (possibly combined with a tax-equalization clause), fringe benefits, payroll slit-models and continued participation in the various plans set up by the employer (deferred compensation, pension, stock options, restricted stock units, *etc.*)

The taxation of stock options granted before the secondment but exercised in Germany, and the taxation of stock options granted during the secondment in Germany but exercised after the return to the United States, often is addressed during tax audits. On September 14, 2006, the German Federal Ministry of Finance issued a decree that addresses this topic and is being applied to the upcoming tax audits. The taxation of stock options is a crucial issue for employers, because they must withhold wage tax on behalf of the employee on every taxable pecuniary benefit, and are liable if they do not do so.

The decree qualifies the pecuniary benefit derived from a grant of option rights for the acquisition of shares as income from employment. Therefore, the tax rate applied to the benefit is the same individual rate as that applied to any other income from employment. As a consequence, the flat rate for income from capital will not be applied to this pecuniary benefit starting in 2009. Income an employee earns from holding the shares after exercising the option or from the subsequent disposal of the shares, is assessed separately, using the rules for income from capital.

For tax purposes, a distinction must be made between tradable and non-tradable options. An option is tradable if it is traded at a stock exchange. For this delimitation, it is irrelevant whether the option is assignable or transferable by succession, or whether it is subject to a period of non-negotiability under the option terms and conditions. The option can be granted by the employer directly or by an affiliated undertaking. What is decisive is that the grant by the third party constitutes a wage for the employee in consideration for his or her services to the employer, and, from the grantor's point of view, is rendered in connection with said employment.

If an option is tradable, a pecuniary benefit accrues to the employee already, by virtue of the grant of the option. Because this option usually is granted as remuneration for services rendered in the past, the pecuniary benefit must be classified according to the circumstances of the period for which the option is granted. If during this period the employee was resident in the United States, the pecuniary benefit may be exempt from German taxation *pro rata temporis* in accordance with the German U.S. Double Taxation Convention, which states that income from employment is taxable in the state where the services are rendered. However, the tax-exempt income is taken into account to determine the progressive tax rate on the income taxable in Germany, according to the exemption with progression rule.

If an employee is granted a non-tradable option to later acquire shares at a specific acquisition price, this constitutes only the

grant of an opportunity. The beneficiary does not accrue a pecuniary benefit until the option is exercised and the quoted price of the shares exceeds the acquisition price. The point in time when the employee is first eligible to exercise the option is non-decisive in this regard. The pecuniary benefit is calculated as the difference between the quoted price upon actual exercise and the exercise price paid by the employee.

A non-tradable option usually is not granted to compensate services rendered in the past, but rather to create an additional motivation for the future. It therefore constitutes remuneration for the period between the grant and the time when it first is possible to exercise the option. If the income earned by the employee in that period is tax-exempt in Germany under the Double Taxation Convention because the services are rendered abroad, the pecuniary benefit accrued upon actual exercise of the option must be apportioned to the period between the grant of the option and the time when exercise is first possible, and must be exempt *pro rata temporis*. The "exemption with progression rule" is applicable to determine the progressive tax rate on the income taxable in Germany.

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The Future of Competing Tender Offers in Germany

Competing tender offers are parallel offers by independent bidders to the same target company. Although competing tender offers are common in other regions, they are rarely seen in Germany. The failed takeover of stock-listed Techem AG in 2006 was the first bidder competition under the German Securities acquisition and Takeover Act, or *Wertpapiererwerbs- und Übernahmegesetzes* (WpÜG).

The high transaction volumes at a takeover of a publicly listed corporation might prevent potential bidders from entering a bidding competition. However, such reluctance might be diminished by the increased funds raised by private equity firms and their increasing activity in the sector of stock-listed companies. In the past year, the press has reported several attempts by private equity investors to take over Continental AG. As a result, competing offers might be seen more frequently.

Advantages and Disadvantages of Competing Tender Offers

Usually, competing tender offers result in higher offer prices for the shareholders. The quoted takeover of Techem led to a final offer price of €55 per share, compared to an initial price of €44 per share. However, bidding competition also has several disadvantages, particularly for the target company. For example, the takeover process consumes a substantial portion of existing management resources. Under the WpÜG, the management and supervisory board of the target company must issue a thorough statement on the offer. This statement must include an opinion on the fairness of the offered price and must be renewed after each increase in the offer price.

Another disadvantage is that contractual partners and banks will await the result of the takeover and the completion of a new shareholder structure before making substantial investments in the target company or granting credit. As a result, the management will endeavor to end the pending phase of a takeover process as soon as possible. Competing offers increase this pending phase, since the WpÜG does not contain any provision regarding the maximum term of a takeover process in case of competing offers.

WpÜG Provisions Regarding Competing Tender Offers

The only WpÜG provision for competing tender offers states that the target company shall not be impaired in its business operations. However, each amendment to a tender offer (*e.g.,* an increase in the offer price) results in an extended offer period for the relevant tender offer and also for the competing offer, to balance out the offers. In theory, tender offers could be extended *ad infinitum*, which is, of course, not acceptable for the target company. Therefore, some scholars in Germany argue that a bidder should be able to increase the offer price only once. The British Takeover Code resolves such dilemma by the so-called "guillotine"—the Takeover Panel may impose a final time limit for announcing revisions to competing offers.

BaFin Intervention

Under German law, it may be possible for the German Federal Financial Supervisory Authority, or *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin), to intervene in the case of extensive competing offers. In general, the BaFin may prohibit a tender offer that causes damage to the target company. In such cases, the BaFin has broad discretionary power. It may even be possible for the BaFin to recommend and enforce an auction process such as that set forth in the British Takeover Code.

Such an auction process might be more appropriate than a total prohibition of further increases in the offer prices. A balance between the interests of the bidder, the target company and the shareholders is possible, and the target company is freed from the restrictions of a current takeover process. In addition, the shareholders receive a higher price for their shares than they would under a prohibition of further increases in the offer price, and they also receive an appropriate term to decide on the acceptance of the

offer. However, such an order by BaFin remains without legal basis in Germany so far.

Conclusions

Competing tender offers cause problems for the target company, and these problems are insufficiently governed by the WpÜG. Because of the incomplete provisions regarding competing takeover offers, it would be advisable for the BaFin to issue certain guidelines. Alternatively, the legislator could enact an auction process similar to the British example. As a result of the increasing activity of private equity investors in the public sector, such a provision could become relevant very soon.

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"Second Basket" of German Copyright Reform Closes Loophole on File-Sharing, Frees Treasures from Studios' Archives

In July 2007, the Lower House of German Federal Parliament (*Bundestag*) passed a long-awaited bill to amend the German Copyright Act. Following the approval by the Upper House in late September 2007, the new law became effective January 1, 2008. The bill, known as the "Second Basket" of copyright reform, is a follow-up to an earlier Copyright Act amendment that went into effect in September 2003. This "First Basket" transferred mandatory provisions of the European Copyright Directive (2001/29/EC) and the World Intellectual Property Organization (WIPO) Performances and Phonograms Treaty (WPPT) into German law. The "Second Basket" addresses several controversial issues that initially were put on hold in order to meet the deadlines set by the Copyright Directive and the WPPT. Among other actions, the bill readjusts the Copyright Act's fair use provisions, provides for a new scheme of statutory remuneration of copyright owners and lifts the ban of the transfer of rights in unknown exploitation methods.

Readjustment of Fair Use Provisions

The new law aligns the Copyright Act's fair use provisions with the requirements of the digital age. Most importantly, it closes a loophole regarding the reproduction of copyright-protected works for private use. Previously, Section 53 of the Copyright Act permitted reproductions of a work to be made for private use, provided that the original was not obviously produced unlawfully. As a consequence, the downloading of music or films from peer-to-peer file-sharing platforms—which under German law constitutes a reproduction of the work—generally was permissible, because in the majority of cases the original was not produced unlawfully (even though it was made available to the public unlawfully). The reproduction of a work from an original unlawfully made available to the public now also excludes the application of the fair use provision.

New Scheme of Statutory Remuneration

The new law also provides for a new scheme to compensate copyright owners for copies made under the fair use provisions of the Copyright Act. In principle, copyright owners (acting through their industry's collecting societies) may claim an adequate compensation for fair use copies from the manufacturers of copying devices and storage media (such as hard drives, memory sticks or blank DVDs). Previously, the amount of compensation was determined in a detailed attachment to the Copyright Act, which proved to be rather inflexible in the face of rapid technological change. After the reform, the amount of compensation will be negotiated between the collecting societies and the manufacturers directly, allowing a more effective remuneration scheme.

Transfer of Rights in Unknown Exploitation Methods

When the German Copyright Act first was enacted in 1965, it included a provision prohibiting the transfer of rights in unknown exploitation methods. Originally intended to protect authors from "selling" all rights in their works across the board, this provision now in many cases impedes the digital exploitation of films and musical works. Since the rights in many works originally were granted only for the analogue exploitation methods known at that time, the rights for digital exploitation (*e.g.,* via DVD, IPTV or mobile TV) now must be renegotiated with the authors or, more frequently, with their heirs. In many cases this has proved to be extremely difficult, particularly with respect to co-authored works, such as films. The new law principally allows the transfer of rights in unknown exploitation methods. With respect to existing contracts, it provides for a transitional arrangement. According to this arrangement, the rights in unknown exploitation methods are deemed also to have been transferred if all relevant exploitation rights known at the time were assigned to another party without any territorial or time limitation. The author of the work may, however, object to such transfer of rights within certain time limits. The author is entitled to a fair and equitable consideration for the exploitation of his or her work. It is expected that this provision will free many digitally unexploited cinematic treasures from film studios' archives. This bill is a major improvement to the German Copyright Act, allowing it to meet the challenges of the digital age.

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Proposed Control of Foreign Investment in German Companies

Despite significant criticism from German economy and industry leaders, the German Federal Government currently plans to enlarge the possibilities of controlling and prohibiting foreign investments in German companies in order to protect "public security and order." The present legal situation in Germany allows restrictions of transactions, especially in the arms industry and the field of encryption technology. A foreign investor that wishes to acquire more than 25 percent of the shares in an arms or encryption manufacturer is obliged to notify the German Federal Ministry of Economics and Technology (FME) of the intended investment. The FME may interdict the proposed transaction within one month.

Pursuant to the recent German Federal Government's proposal to amend the German Foreign Trade and Payments Act (*Außenwirtschaftsgesetz*) as well as the related directive (*Verordnung zur Durchführung des Außenwirtschaftsgesetzes*), the FME may examine any investment leading to a shareholding of at least 25 percent in a German company by a foreigner or a foreign company, or by a company with a foreign shareholding of at least 25 percent. Contrary to the origin of the discussion, the FME's right to examine or prohibit such transactions shall not be limited to investments by public funds, but extend to all foreign investors and all sectors. After having examined the proposed investment, the FME may authorize it, authorize it under conditions or even prohibit it, provided that that "public security and order" require such measures. The period of time in which the FME may commence its examinations shall be limited to three months from signing or the publication of the resolution concerning the offer, or the acquisition of control.

Under the proposed amendment, however, the foreign investor shall no longer be obliged to notify the FME of the intended investment. The draft act does not yet establish criteria for when "public security and order" shall be deemed to be in danger of being breached. Also, by equally extending to foreign investors resident in the European Union, the draft act raises concerns regarding compliance with European law and is currently being reviewed by the European Commission.

As a result, future share purchase or swap agreements concerning a shareholding being possibly precarious with respect to the (amended) German Foreign Trade and Payments Act may be concluded on the condition subsequent of an interdiction by the FME. Thus, such agreements may become retroactively invalid upon interdiction by the FME. This provision shall motivate foreign investors to notify the FME of their intended investments—even if they are not obliged to do so—in order to abbreviate the time of legal insecurity from three months to only one month. If an investment is prohibited by the FME, the transaction will need to be reprocessed. If this is not possible, as in the case of a stock market transaction, the shares shall be sold by force. Because of the legal insecurity, it will be advisable to ask the FME at an early stage of the transaction, at least before signing, to provide a document of compliance of the intended transaction with the provisions of the (amended) German Foreign Trade and Payments Act.

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McDermott News from Germany

Dr. Stephan Brandes recently joined the Munich office as a partner in the corporate law and mergers and acquisitions (M&A) practice. His main focus is on stock corporation law and corporate restructuring. In particular, he has specific experience with European corporate law, and is also well-versed in M&A transactions, capital markets, insolvency and insurance matters. Stephan previously worked for Sherman & Sterling.

In January 2008, Stefan Fink transferred from the Düsseldorf office to join the corporate practice in the Munich office. As a partner he advises on all aspects of corporate real estate law, including real estate transactions, real estate transaction finance, real estate outsourcing, commercial tenancy law, public and private construction law and project development.

In February 2008, Paul Melot de Beauregard will transfer from the Düsseldorf office to launch the employment practice in the Munich office. His practice covers the entire spectrum of national and international labor and employment law. His special focus is on restructuring, close-downs, transactions and negotiations with works councils. Additionally, he also advises on service agreements with board members, managing directors and senior executives as well as on pensions and outsourcing.

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