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PRIVATIZATION IN THE FORMER GERMAN DEMOCRATIC REPUBLIC

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The situation in the former German Democratic Republic (East Germany) differs quite substantially from the situation in other Eastern European countries. Here, the Federal Republic of Germany, a developed, industrialized country, took over the former German Democratic Republic ("the former GDR"). Speaking as a corporate lawyer, you could compare the process to a purchase of the assets of a bankrupt company.

The unification process was quite orderly. On August 31, 1990, the Unification Treaty,[1] the centerpiece of this process, was entered into by the Federal Republic of Germany and the German Democratic Republic. It is a surprisingly brief document, containing only forty-five rather short sections and three exhibits. Thereafter, on October 3, 1990, five new states created on the territory of the former GDR joined the Federal Republic.[2]

I would now like to present an overview of major issues concerning the privatization of industry in the former GDR.[3]

The first question is: "What legal regime applies to the privatization?" The former GDR has a great advantage over other Eastern European countries because West German law (the law of the Federal Republic of

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1. Treaty Between the Federal Republic of Germany and the German Democratic Republic on the Establishment of German Unity (*Einigungsvertrag*), Aug. 31, 1990, BGBL. II, at 889 [hereinafter Unification Treaty] and Agreement Between the Federal Republic of Germany and the German Democratic Republic on the Implementation and Interpretation of the Unification Treaty, Sept. 18, 1990, BGBL. II, at 1239, both ratified in the Federal Republic of Germany by Act, Sept. 23, 1990, BGBL. II, at 885.

2. Brandenburg, Mecklenburg - Vorpommern, Sachsen, Sachsen - Anhalt, and Thüringen.

3. *See* Michael Gruson & George F. Thoma, *Investments in the Territory of the Former German Democratic Republic*, 14 FORDHAM INT'L L.J. 540, 540-77 (1990-91) [hereinafter Gruson & Thoma, *Investments*] and Michael Gruson & George F. Thoma, *Investments in the Territory of the Former German Democratic Republic—A Change of Direction*, 14 FORDHAM INT'L L.J. 1139, 1139-58 (1990-91) [hereinafter Gruson & Thoma, *Change of Direction*].

Germany) was made applicable to the territory of the former GDR.[4] However, this sounds simpler than it is. There are at least three major exceptions to the laws of the Federal Republic of Germany.

The first exception is that several hundred statutes of the Federal Republic do not apply, or apply only partially or under certain conditions, to the territory of former GDR.[5] All of these statutes are listed in the Unification Treaty in Annex I.

The second major exception is that in certain subject areas the law of the former GDR remains in force either as German federal law or as state law.[6] Laws relating to areas under the Basic Law of the Federal Republic ("Grundgesetz"), the German Constitution, are reserved to the legislative jurisdiction of the German states and survive as state law of the five new states.[7] These laws, however, survive only to the extent that they are consistent with a number of authorities: the German Constitution; all other West German law applicable to the territory of former GDR; and the directly-applicable European Community law.[8] Furthermore, Annex II to the Unification Treaty enumerates certain statutes of the former GDR, which, although not in the exclusive jurisdiction of the states, remain in force with or without modifications.[9] Again, they remain in force only to the extent that they are consistent with the German Constitution and the directly-applicable laws of the European Communities.[10] An important example of a surviving law of the former GDR is the bankruptcy law.[11]

The third exception is that certain statutes adopted by the former GDR after the signing of the Unification Treaty on August 31, 1990, but before unification, also survived to the extent that they have been agreed upon by

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4. Unification Treaty, *supra* note 1, art. 8.

5. *Id.*, annex I.

6. *Id.*, art. 9.

7. *Id.*, art. 9(1).

8. *Id.*

9. Unification Treaty, *supra* note 1, annex II.

10. Unification Treaty, *supra* note 1, art. 9(2). Additional statutes of the former GDR that survive as law of the Federal Republic, subject to art. 9(4) of the Unification Treaty, *supra* note 1, are enumerated in art. 3 of the Agreement on the Implementation and Interpretation of the Unification Treaty, *supra* note 1.

11. Unification Treaty, *supra* note 1, annex II, ch. III, div. A, subdiv. II, no. 1. The bankruptcy law of the former German Democratic Republic (*Gesamtvollstreckungsverordnung*), June 6, 1990, GBL. I No. 32, at 285, *modified by* the Second Regulation Concerning Bankruptcy—Suspension of Proceedings (*Zweite Verordnung über die Gesamtvollstreckung - Unterbrechung des Verfahrens*), July 25, 1990, GBL. I No. 45, at 782, survives with certain modifications as federal law for the territory of former GDR under the name *Gesamtvollstreckungsordnung*.

the Federal Republic and the former GDR.[12] The surviving statutes adopted after August 31, 1990, and the surviving statutes enumerated in Appendix II to the Unification Treaty survive as federal law only if they deal with matters that the German Constitution delegates exclusively to the federal government or makes subject to preemption by federal statutes and if federal statutes have already preempted the matter.[13] Otherwise, they survive as state law of the five new states. In addition, the treaties of the European Communities and the international treaties of the Federal Republic apply to the territory of the former GDR.[14] And finally, the Unification Treaty itself contains rules of law.

Thus, although an organized and developed legal system applies to the territory of the former GDR, it may be difficult in some cases to ascertain which law applies and whether the applicable law is federal or state law. Furthermore, the laws of the former GDR that did not survive may remain relevant, for example, in determining questions of property ownership.

The second question relating to privatization is: "What is being privatized?" The government-owned enterprises that existed in the former GDR before unification were not separate legal corporate entities, but rather they were parts of the general government structure of the country. In its last days of existence, the German Democratic Republic passed a law that transformed all enterprises into corporations as of July 1, 1990.[15] The large enterprises were transformed into stock corporations ("AG") and the smaller enterprises were transformed into limited-liability companies ("GmbH").[16] In essence, most of the GmbHs were subsidiaries of AGs. The statute allowed a period of time for taking the legal steps necessary to

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12. Unification Treaty, *supra* note 1, art. 9(3). These statutes must be consistent with the Constitution of the Federal Republic and directly applicable laws of the European Communities. *Id.* art. 9(4).

13. Unification Treaty, *supra* note 1, art. 9(4).

14. *Id.*, arts. 10, 11.

15. Act on Privatization and Reorganization of State-Owned Property (*Gesetz zur Privatisierung und Reorganisation des volkseigenen Vermögens (Treuhandgesetz)*), June 17, 1990, GBL. I No. 33, § 11, at 300 [hereinafter the Trusteeship Law]. The Trusteeship Law remains in effect with certain modifications according to art. 25 of the Unification Treaty, *supra* note 1. Some enterprises were already transformed prior to June 17, 1990, by virtue of the Regulation Concerning the Transformation of State-Owned Enterprises into Corporations (*Verordnung zur Umwandlung von volkseigenen Kombinaten, Betrieben und Einrichtungen in Kapitalgesellschaften*), Mar. 1, 1990, GBL. I No. 14, at 107.

For a discussion of the legal structure of the enterprises in the territory of the former GDR and their transformation into corporations, see Gruson & Thoma, *Investments*, *supra* note 3, at 545-48.

16. Trusteeship Law, *supra* note 15, § 11(1).

incorporate, that is, creating the basic corporate documents and opening balance sheets to be filed with the commercial register.[17] However, corporations formed prior to the enactment of the statute had no charters or balance sheets. Thus, prior to the completion of the incorporation process and the filing with the commercial register, those companies were considered companies "in formation" and had to indicate this status in their name by adding the letters "i.A." ("im Aufbau").[18] Treuhandanstalt, an institution created under public law[19] and established in connection with the first transformation ordinance of March 1990,[20] is the direct or indirect owner of the shares of all newly established corporations.

There was one problem: most corporations would have been insolvent immediately upon formation and would have had to file bankruptcy petitions. The reason is that the method applied in the former GDR for evaluating the assets and liabilities of enterprises differed substantially from the methods used in countries with a free-market system and, in particular, from the accounting principles of the Federal Republic. Under the law of the Federal Republic, the management of an insolvent company is legally obligated to file a bankruptcy petition.[21] The German solution to this problem is very interesting and innovative.

As part of the formation process, the newly formed corporations have to prepare an opening balance sheet in Deutsche Mark ("DM") in accordance with the newly adopted DM Opening Balance Sheet Law.[22] In

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17. *Id.*, §§ 19, 21.

18. *Id.*, § 14.

19. *Bundesunmittelbare Anstalt des öffentlichen Rechts.* Unification Treaty, *supra* note 1, art. 25(1). Treuhandanstalt has legal personality. *Id.*; *see also* Trusteeship Law, *supra* note 15, § 2.

20. Treuhandanstalt was originally established by Decree Regarding the Establishment of the Anstalt for Trust Administration of State-Owned Property (*Beschluss zur Gründung der Anstalt zur treuhänderischen Verwaltung des Volkseigentums (Treuhandanstalt)*), Mar. 1, 1990, GBL. I No. 14, at 107, and was reorganized by the Trusteeship Law, *supra* note 15. *See* Unification Treaty, *supra* note 1, art. 25, annex II, ch. IV, subdiv. I, nos. 6-9; Agreement on the Implementation and Interpretation of the Unification Treaty, *supra* note 1, art. 3, nos. 10-11. See *supra* note 15 for a reference to the first transformation ordinance of Mar. 1, 1990.

21. Stock Corporation Law (*Aktiengesetz*) § 92, Law Concerning Limited Liability Companies (*GmbH Gesetz*) § 64. *See generally* Meyer-Landrut, *Überschuldung als Konkursgrund*, in Festschrift für Karlheinz Quack, at 335 (1991).

22. Law on the Opening Balance Sheet in Deutsche Marks and the New Determination of Capital (*Gesetz über die Eröffnungsbilanz in Deutscher Mark und die Kapitalneufestsetzung (D-Markbilanzgepsetz)*), Apr. 18, 1991, BGBL. I, at 971 [hereinafter DM Opening Balance Sheet Law]. *See* Trusteeship Law, *supra* note 15, § 20.

For a discussion of the DM Opening Balance Sheet Law and the assets, liabilities, and capitalization of the new corporations, see Gruson & Thoma, *Investments*, *supra* note 3, at

order to avoid immediate liquidation of a large number of companies, the DM Opening Balance Sheet Law provides that a company may adjust its DM opening balance sheet with an interest bearing adjustment claim against the owner of the company, which, in most cases, is Treuhandanstalt.[23] This adjustment claim is in an amount equal to the otherwise existing deficit on the DM opening balance sheet, i.e., the excess of liabilities over assets that are not covered by equity.[24] The adjustment claim covers the otherwise existing equity deficiency but does not create equity. The right to obtain an adjustment claim, however, is conditional: Treuhandanstalt (or respectively any other owner) must reject the claims of a company if it believes that the company does not offer reasonable prospects for a successful rehabilitation.[25] In the case of companies that are subsidiaries of a stock corporation (AG), which in turn are owned by Treuhandanstalt, the adjustment claim is directed against the parent company AG, and the AG has an adjustment claim against Treuhandanstalt if on a consolidated basis it shows a deficit on its DM Opening Balance Sheet. If a company with an adjustment claim on its balance sheet is purchased by an investor, the claim against Treuhandanstalt is not part of the assets purchased. Treuhandanstalt requests the investor to waive that claim and to substitute the missing equity with a capital contribution. However, this accounting trick has made it possible for newly formed corporations to take over the assets and liabilities of the business enterprises of the former GDR.

Treuhandanstalt primarily has the statutory task of privatizing the companies it owns;[26] a duty to rehabilitate other companies is of secondary importance.

The third question is: "What are the main obstacles to privatization?" The most important obstacles are private ownership claims relating to real estate and companies. It was a basic principle of the unification that private ownership of property must replace the state ownership of the former GDR. As a corollary, it was decided that former owners that have been illegally deprived of their property by the government of the former GDR, or even during the preceding period by the Third Reich, should be able to obtain restitution by reconveyance of their property. This right may collide with the rights of present owners, who may have acquired the property in good faith, or with the interest of the community in housing

548-52.

23. DM Opening Balance Sheet Law, *supra* note 22, § 24(1).

24. *See* Commercial Code (*Handelsgesetzbuch*) § 268(3).

25. DM Opening Balance Sheet Law, *supra* note 22, § 24.

26. Trusteeship Law, *supra* note 15, § 8; *see also id.* § § 1(1), 2(6).

and the promotion of industry and trade. The claims of prior owners also creates a major impediment to privatization. The original laws dealing with the rights of prior owners and investments by new investors[27] gives a strong preference to the prior owners and entitles them generally to obtain a reconveyance, relegating them only in few cases to monetary compensation. Such cases are, for instance, good faith acquisitions of real property or the use of the real property for public purposes or as part of a commercial enterprise. Later amendments[28] to the laws, however, have recognized that the restitution claims of prior owners seriously hinder privatization and, thus, shifts the preference to the investor, away from the prior owner.

If an investor wishes to invest in real estate or in a company by way of purchase or lease, and if this property or the ownership interests in this company are subject to a claim for reconveyance by a former owner, the investor must obtain an investment certificate that states that the investment meets one of the investment purposes of the Investment Priority Law.[29] An investment purpose exists in the case of a sale or lease of real property or buildings if the real property or buildings are to be used

(i) for maintaining or creating of jobs, especially by means of establishing or maintaining a manufacturing or service business;

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27. The Law Concerning Regulation of Unresolved Property Issues (*Gesetz zur Regelung offener Vermögensfragen* (*Vermögensgesetz*)) and the Law Relating to Special Investments in the German Democratic Republic (*Gesetz über besondere Investitionen in dem in Artikel 3 des Einigungsvertrages genannten Gebiet* (*Investitionsgesetz*)), both adopted in the last days of the former GDR, became law of the Federal Republic, Unification Treaty, *supra* note 1, annex II, ch. III, div. B, subdiv. I, nos. 4, 5. These laws are discussed in Gruson & Thoma, *Investments*, *supra* note 3, at 552- 65.

28. Law for the Removal of Obstacles to Privatization of Enterprises and for the Promotion of Investments (*Gesetz zur Beseitigung von Hemmnissen bei der Privatisierung von Unternehmen und zur Förderung von Investitionen*), Mar. 22, 1991, BGBL. I, at 766, and Law Regarding Changes of the Property Law and other Provisions (*Gesetz zur Änderung des Vermögensgesetzes und anderer Vorschriften - Zweites Vermögensrechtsänderungsgesetz*), July 14, 1992, BGBL. I, at 1257. Part of the 1992 law was the Law Regarding the Priority of Investments Over Prior Reconveyance Claims According to the Property Law (*Gesetz über den Vorrang für Investitionen bei Rückübertragungsansprüchen nach dem Vermögensgesetz - Investitionsvorranggesetz*) [hereinafter the Investment Priority Law]. The Investment Priority Law superseded the Law Relating to Special Investments, *amended by*, *supra* note 27.

The Law for the Removal of Obstacles to Privatization is discussed in Gruson & Thoma, *Change of Direction*, *supra* note 3.

29. *See supra* note 28.

(ii) for the creation of new housing or rehabilitation of abandoned or uninhabitable housing or housing likely to be (the building or rehabilitation of single or two-family houses constitutes an investment purpose only if it is undertaken as part of a municipal building effort); or
(iii) for developing the infrastructure required for investments or induced by investments.[30]

An investment purpose exists in the case of a sale or lease of a business enterprise or real property required by a business enterprise if the investment is to be used

(i) for creating or maintaining jobs or to make investments possible that improve competitiveness;
(ii) to continue or rehabilitate a business enterprise where the former owner is not able to do so; or
(iii) to avoid liquidation or bankruptcy of a business enterprise due to the inability to meet payment obligations or due to excessive indebtedness, if according to a commercial evaluation such inability or indebtedness is unavoidable.[31]

A former owner who has filed a claim for reconveyance specific enough to define the property affected must be given notice of the procedures regarding an investment certificate and the proposed investment. Within two weeks following the notification, the former owner must decide whether or not he opposes the investment. If he does, he has to offer his own investment plan within six weeks from the day he received the notice of the proposed investment. Notifying the former owners is not required if the anticipated length of the procedure would jeopardize the success of the proposed investment.[32]

After the 1991 amendments, and even more so after the 1992 amendments,[33] it is apparent that the advantage given to prior owners is largely taken away—the preference of prior ownership claims is still pronounced as a general principle, but has been severely limited by very broad exceptions in favor of investors.

30. Investment Priority Law, *supra* note 28, § 3(1).
31. *Id.* § 3(2).
32. *Id.* § 5.4.
33. *See supra* note 28.

One other event removed a very large number of private ownership claims that could have been obstacles to privatization. The Joint Declaration of the governments of the Federal Republic of Germany and the former GDR[34] stated that confiscations on the basis of occupation law that were executed in the territory of the former GDR between 1945 and 1949 are no longer reversible. During that period, all the large land holdings and basically all large companies were expropriated by the Russian military government. Neither the Joint Declaration nor the Unification Treaty addresses the issue of compensation. Article 143(3) of the Constitution of the Federal Republic, which was added by virtue of the Unification Treaty, specifically recognized the continued validity of these expropriations.[35]

A lawsuit was brought promptly by persons whose property had been expropriated between 1945 and 1949. On April 23, 1991, the German Constitutional Court (Bundesverfassungsgericht) upheld the validity of Article 143(3) of the German Constitution[36] thereby recognizing the continued validity of these expropriations under the German Constitution.[37] The principal argument of the Court was that the expropriations took place outside of the territory of the Federal Republic and before the Basic Law became the Constitution of the Federal Republic.[38] Furthermore, German conflict-of-laws rules relating to foreign expropriations recognize expropriations by a foreign country of property located in its territory, even if such expropriations violate that country's laws.[39] This rule, based on territoriality, is consistent with the German Constitution.[40] The Court held,[41] however, that the constitutional rule of equal treatment requires compensation to the former owners of property expropriated between 1945 and 1949 because the Unification Treaty provides for the compensation, either by reconveyance or money damages, of former owners of property,

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34. Joint Declaration of the Governments of the Federal Republic of Germany and the German Democratic Republic Concerning Regulation of Unresolved Property Issues (*Gemeinsame Erklärung der Regierung der Bundesrepublik Deutschland und der Deutschen Demokratischen Republik zur Regelung Offener Vermögensfragen*), no. 1. The Joint Declaration is part of the Unification Treaty (annex III); Unification Treaty, *supra* note 1, art. 41(1).

35. Unification Treaty, *supra* note 1, art. 4, no. 5.

36. Federal Constitutional Court ruling of April 23, 1991(BVerfG, Urt. 23.4.1991 - 1 BvR 1170, 1174 u. 1175/90-) (published in 1991 *Zeitschrift für Wirtschaftsrecht* (ZIP) 614)

37. *Id.* at 614, 619-20.

38. *Id.* at 620-21.

39. *Id.*

40. *Id.*

41. *Id.* at 614, 619-20.

which was expropriated other than on the basis of occupation law between 1945 and 1949.[42] The far-reaching importance of the decision for investments in the former GDR becomes clear when one realizes that more than thirty percent of the territory of the former GDR, all large corporations, and many medium-sized enterprises, were expropriated on the basis of the occupation law between 1945 and 1949.[43]

Another major impediment to investments in the territory of the former GDR is that the investors must deal with serious environmental problems and face potentially substantial environmental liabilities. The Unification Treaty and statutes that followed tried to improve the situation in favor of investors. Currently, an investor in a commercial facility may obtain a release from liability for environmental damages caused by such facility before July 1, 1990.[44] This release, however, does not cover environmental liabilities under private law to third parties. The 1991 amendments,[45] however, have given the appropriate authorities broad discretionary power to release environmental violators from the obligation to pay damages to third parties for environmental violations and to substitute the state as the debtor of the monetary damage claims of the third parties.[46] Accordingly, the state has made great efforts to reduce the environmental obstacles to investments.[47]

Another major problem, which almost every investor in the territory of the former GDR encounters, is that most enterprises are hopelessly over-staffed. Pursuant to the Unification Treaty, the labor law of the Federal Republic has taken effect in the territory of the former GDR with some changes.[48] Moreover, parts of the labor law of the former GDR remain in force for a transition period.[49] The labor law of the Federal Republic includes statutory employment protection, such as protection against unjustified dismissals. An investor attempting to reduce the work force of the acquired enterprise will have to deal with job security

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42. *Id.* at 622-23.

43. *See* Gruson & Thoma, *Change of Direction*, *supra* note 3, at 1157 n.113.

44. Environmental Law (*Umweltrahmengesetz*), June 29, 1990 (of the former GDR), GBL. I No. 42, at 649, which survived with some modifications; Unification Treaty, *supra*, note 1, annex II, ch. XII, subdiv. III, no. 1.

45. Law for the Removal of Obstacles to Privatization, *supra* note 28.

46. The Environmental Law, *supra* note 44, *amended by* the Law for the Removal of Obstacles to Privatization, *supra* note 28, art. 12.

47. *See* Gruson & Thoma, *Investments*, *supra* note 3, at 566-67; Gruson & Thoma, *Change of Direction*, *supra* note 3, at 1154-56.

48. Unification Treaty, *supra* note 1, annex I, ch. VIII.

49. Unification Treaty, *supra* note 1, annex II, ch. VIII.

regulations. It should also be noted that according to Section 613a of the German Civil Code, even the purchaser of a business or part of a business by way of purchase of assets assumes, by act of law, all rights and duties arising from the existing employment contracts. That means that the purchaser of a business cannot immediately adjust the number of employees to the actual needs of the business, but has to take over the current work force, which may be much larger than required. In addition, he can only reduce the work force in accordance with the laws that protect employees against dismissals. Dismissals must be "socially justified" and mass lay-offs must follow certain procedures and have a social compensation plan.[50]

In general, privatization is going reasonably well. Treuhandanstalt is expected to complete the privatization in substantial part by the end of 1993, and at that time to cease being an active seller of companies and real properties. After that time, Treuhandanstalt's only functions will be to hold those properties that could not be sold or liquidated in some way, and to administer existing acquisition contracts. The second function is important because the buyers of property from Treuhandanstalt or a company owned by Treuhandanstalt have to enter into very substantial covenants concerning investment obligations, continued employment, and windfall profits on the sale of real estate. If windfall profits are obtained, they must be turned over to Treuhandanstalt or another seller. In any event, the aim is that by the end of 1993 privatization will be complete.

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50. *See* Gruson & Thoma, *Investments*, *supra* note 3, at 567-73.