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Parent-Subsidary Relations under German Law

Conflict Rules Governing Parent-Subsidiary Relations Under German Law

I. Introduction: Parent-Subsidiary Relations as a Problem of Company Law

1. THE PROBLEM

Traditionally a business corporation is viewed as an independent legal entity, the main purpose of which is the common economic interest of its shareholders. The underlying concept of practically all corporate statutes is that the shareholders have identical interests. So the statutes extensively regulate the allocation of power between the shareholder-owners and management of a single business corporation. The regulation of the internal structure of a corporation makes it clear, that the decision-making process is regarded as a problem related only to one special business enterprise.

This concept of an independent legal unit does not take into account the possible dangers for the corporation itself, its minority shareholders, and its creditors which may arise when the corporation becomes subject to the influence of another business enterprise. A majority shareholder doing business in the same or a related field as the corporation may not be willing to restrict his role merely to supply the required capital. He is likely to exercise his influence in a way which is most profitable to his over-all business activities.

So a common interest of the shareholders can no longer be taken for granted. Contrary to its legal independence in form, the corporation is dependent on decisions which are not made by the corporate organisms,

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and not necessarily in the corporate interest. For the majority shareholder can use his influence so that the business of the dependent corporation provides little profit for the corporation itself, as long as his other business units are profiting.

The sale of corporate products without fair consideration, or the limitation on special products to avoid competition are only two examples of possible disadvantages.[1] The detrimental effects on the minority shareholders' investment are self-evident. Similarly the position of the creditors is endangered when the corporation is no longer managed for the corporate benefit.

On the other hand, there are strong economic arguments in favor of a business organization which offers the possibility of subjecting a corporation to the interest of another enterprise. The combination of various enterprises may lead to a suppression of competition under the unified control of firms which form a "horizontal" combination, that is a combination of firms engaged in the same line of manufacture at the same stage of production. Or so-called "vertical" combinations may be formed of a number of firms engaged in the production of a commodity at various stages of manufacture, including *e.g.* sources of supply, production means, and trade organizations.[2]

It is clear that intelligent control has tremendous advantages over blind struggle. A highly influential school of thought in the Germany of the twenties argued that the economic value of an "enterprise as such" should prevail over the interests of unscrupulous, speculating investors.[3] Although this theory is criticized today,[4] it shows which interests have to be balanced out: The power of a majority shareholder who wants to increase the effective management of an expanded business enterprise, may be opposed by the outside or minority shareholders.

2. THE DEVELOPMENT IN GERMANY

The economic development in Germany proved that the conflicts of interests do not only exist in theory. Combinations of legally independent enterprises in modern industry were already known before 1914. A first climax of the growing concentration of business enterprises was reached at the end of the twenties.[5] At that time the legal literature took an increasing

[1] *See* Zöllner, JuS 1968, p. 299.

[2] *See* Baumbach-Hueck, § 291 at 861, and Zöllner JuS 1968, p. 302.

[3] *See* survey in Mestmäcker, Konzerngewalt, at pp. 13 ff., and his analysis of decisions of the German Reichsgericht which were in favor of this doctrine at pp. 139 ff.

[4] *See* Mestmäcker, on *cit. supra,* at p. 13, and Resch pp. 141 ff.

[5] *See* Rasch, p. 19.

interest in the structural problems of corporations as a result of the economic development.[6]

But neither the amendments of the corporate law in 1931, nor those of 1937, introduced rules of greater importance on the respective rights of shareholders and management of corporations which are related to other business enterprises.[7] Since the data on the concentration in the business field were known this attitude of the German legislatures can only be interpreted as tolerating this development.[8]

Government investigations in the period between 1954 and 1960 showed that the concentration in the West German economy was continuously increasing.[9] When the German Corporate Code (Aktiengesetz) was extensively amended in 1965, the legislature attempted to face "the reality of the dialectic contradiction between the legal separateness and factual interdependence of affiliated or 'related companies.' "[10] By that time, approximately seventy per cent of the companies were related to other business enterprises.[11] For the first time the legislature recognized that this development required far-reaching innovations in corporate legislation. The result is a comprehensive set of rules governing "related enterprises," the "Konzernrecht."[12]

3. THE SCOPE OF THE NEW GERMAN PARENT-SUBSIDIARY RULES

A. The problem of protecting the individual enterprise which is interrelated to another business enterprise exists, regardless of the form in which the enterprises are legally organized. A partnership, a close corporation or a publicly held corporation may exercise influence on all sorts of business organizations. So it was proposed to develop a unitary concept of "enterprise law" providing a framework for an overall company law reform and including the law of "related enterprises."[13] But these proposals were regarded as too far-reaching.

Instead, the new rules governing "related enterprises" were introduced as part of the reform of the German Corporation Code (Aktiengesetz).

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[6] *See* Rasch, p. 29, and Stein p. 93.

[7] The fragmentary provisions of the 1937 law contained a definition of a combination ("Konzern"), and some other regulations of minor importance, but did not regulate the conflict of the interests among majority-, minority-shareholders and creditors. *See* Kellman, BB 1969, p. 1510, Lehmann-Dietz, p. 486, Rasch, p. 19.

[8] *See* Kellman, BB 1969, p. 1510.

[9] *See* Bericht 1964, p. 13; and Rasch, p. 21.

[10] Thus Stein, p. 105.

[11] *See* Gessler, BB 1965, p. 681, and Würdinger, p. 254.

[12] "Konzern" means in German a combination of enterprises, not a single firm.

[13] *See* Kropff BB 1965 p. 1281, and Stein p. 101.

Consequently these rules apply only if one of the enterprises is an "Aktiengesellschaft" (stock corporation) or a "Kommanditgesellschaft auf Aktien" (association limited by shares).[14]

The "Aktiengesellschaft" is one of the two important kinds of business organizations which are recognized under German law. This type is the German equivalent of the American publicly owned business corporation. The "Gesellschaft mit beschränkter Haftung" (GmbH—company with limited liability) is comparable to the American close corporation.[15] As the "Aktiengesellschaft" is practically the most important form of business organization[16] the new rules on parent-subsidiary relations are of great importance. Besides these rules have become the model for similar provisions of the GmbH statute which is being reformed.[17]

B. The new law did not undertake to put a brake on the trend toward further concentration. The explanatory statement accompanying the Government draft bill expressly states, that the regulation of concentration is not a problem to be dealt with in the Corporation Code.[18] This task is left to the Law Against Restraints of Competition which contains limited provisions on concentration.[19]

C. The new law on parent-subsidiary relations is based on a relatively simple concept: it distinguishes between those relations which are based on the formation of a "contract of domination" and those which exist as a matter of fact as one business enterprise is controlling another enterprise. The new law grants a parent substantial power to direct the subsidiary for the economic benefit of the whole combination. The price for the legal recognition of the shift of control from the organs of the subsidiary to the parent, is compliance with the rules which safeguard the interests of the subsidiary corporation, its outside or minority shareholders and its creditors.

On the other hand the law still permits establishment of parent-subsidiary relations without a contract of domination being formed. Originally it was proposed to prohibit a parent from exercising any influence on the management of a subsidiary.[20] But finally a more pragmatic solution was adopted in order to deter parents from abusing their power

[14] *See* §§ 291, 292, 311 ff. of the Aktiengesetz 1965. An English translation of the statute is available (Mueller-Galbraith). Sections hereinafter referred to are those of the Aktiengesetz.

[15] *See* Steefel/v. Falkenhausen, 52 CORNELL L.Q. 518 (1967).

[16] *See* Rasch, p. 42.

[17] *See* Lehmann-Dietz, p. 487.

[18] *See* Kropff, Bergründung, p. 374.

[19] *See* Haskell, THE BUSINESS LAWYER, 424 (1969); Stein, p. 104.

[20] *See* Kropff, Begründung p. 375.

of control by virtue of the ownership of a majority interest in the subsidiary.

To make sure that the parent is not exploiting the subsidiary the law imposes on the subsidiary the duty to prepare a comprehensive report of its business dealings with the parent, or any other related business unit. This requirement proved to be highly effective and caused most parents to form a contract of domination thus submitting themselves to the rules protecting the interests of the other groups involved.

II. The New German Law Governing Parent-Subsidiary Relations

1. DIFFERENTIATION OF ENTERPRISE RELATIONS

The new law recognizes different types of relations which may exist between legally independent enterprises.[21] The definitions of these various forms reflect varying degrees of influence or control by one business enterprise over another. The legal protection of the interests involved varies according to these differentiations.

Section 16 defines enterprises which are related by virtue of ownership of a majority interest in one such enterprise by another enterprise. Section 17 deals with dependent and dominating enterprises, the legal qualification being based merely on the possibility of one enterprise to exercise a dominating influence on the other one. There is a legal presumption that an enterprise holding a majority interest is dominating the other enterprise.

It is doubted whether any value is to be found in the distinction between a majority holder who is "able to exercise dominating influence" (Section 17) and a holder of a majority interest (Section 16).[22] In fact the Government had proposed to define an enterprise holding a majority interest as a dominating enterprise. But the legislature decided that such enterprises should not be subjected to the strict rules governing parent-subsidiary relations, if they prove that they do not exercise their influence.[23] This was the reason for inserting Section 16.

Section 18 (1) defines the socalled subordination combine (Unterordnungskonzern) as follows:

> If a dominating and one or more dependent enterprises are joined by the uniform direction of the dominating enterprise then they constitute a combine, ...

[21]The statute does not define the term "enterprise" which has to be interpreted by the courts now. For further aspects, see Kropff, BB 1965, p. 1285.

[22]*See* Kropff, BB 1965 p. 1284.

[23]*See* Kropff, Bergründung, p. 28, and BB, 1965, p. 1283.

The coordination combine, on the other side, is formed by enterprises without one enterprise being dependent on the other.

Finally, the law provides special regulations for mutual or reciprocal ownership, by which each of two or more business corporations hold an interest in the other of twenty-five per cent or more. But the rules concerning this form of connection apply only to enterprises with a domestic domicile and are of no interest if a parent or a subsidiary is a foreign corporation.

2. "RELATED ENTERPRISES"

All above mentioned forms of connections are called "related enterprises" in the terminology of the Corporate Code, Section 15. In addition parties to enterprise contracts (Sections 291, 292) are defined as "related enterprises."

The law governing the various forms of interlocked enterprises is contained in a considerable number of single provisions, which apply to related enterprises as defined in Section 15, or to relations as defined in Sections 16–18. These provisions are commonly referred to as the law governing related enterprises in a broader sense, as opposed to the rules of Book Three of the new Corporate Code which is expressly entitled 'Related Enterprises'.[24] Although the provisions of the third Book constitute the most important part of the law on parent-subsidiary relations, short reference must be made to the major duties which are contained in other provisions.

In the first place there are a considerable number of reporting requirements which are to provide the investors, and creditors with information about the holdings, acquisitions, and corporate interrelations. So any business enterprise owning more than twenty-five or fifty per cent of the shares of a stock corporation with a domestic domicile must notify the latter which has to publish the notification, Section 20 (1) and (4). Failure to comply with this requirement causes suspension of the shareholder's rights in the corporation.

Additional duties to inform exist for related enterprises within Section 15, *e.g.*: Under Section 90 (1) the executive board [25] has to report to the supervisory council on business events of substantial importance concerning related enterprises, or the supervisory council[26] may request such a

[24] *See, e.g.*, Baumbach-Hueck, p. 853; Zöllner, JuS 1968, p. 303.

[25] For a comparison between the American board of directors, and the organs of a German stock company, see Steefel/v. Falkenhausen, 52 CORNELL L.Q. 518 (1967).

[26] *Id.*

report, Section 90 (3); similarly every shareholder must at his request be given information in the shareholder's meeting regarding the legal and business relations of a corporation with a related enterprise, Section 131 (1), if this does no considerable damage to the enterprises involved, Section 131 (3).

Every report of the management must include statements on these relations too, Section 160 (3) (nos. 8–10). Accounts receivable from related enterprises are to be shown separately in the annual balance sheet, Section 151 (1) (III no. 10), as well as liabilities toward related enterprises. These provisions were introduced because one objective of the new law is to provide a clearer picture of the corporate interrelationship?[27]

A second kind of duties is purported to balance out the dangers for the capital of the related enterprises and the creditors. So a dependent enterprise may not subscribe to shares of the dominating enterprise, nor an enterprise held by a majority to shares of the corporation holding the majority, Section 56 (2). Other restrictions concern the acquisition of shares by dependent enterprises, Section 71.

A third group of provisions protects the independence of the decision-making process of a dependent corporation. Thus the granting of credits by dominating or dependent corporations to the legal representatives of related enterprises is subject to special conditions, Section 89 (2), (cf. Section 115 (1) for members of the supervisory council). On the other side, the law protects the dominating corporation, too, as the voting rights may not be exercised for shares which belong to a dependent enterprise, Section 136 (2). Otherwise the management of the dominating corporation could influence its own shareholder-meeting resolutions.

3. POWER OF CONTROL AND RESPONSIBILITIES UNDER A CONTRACT OF DOMINATION

Book Three of the Act of 1965 is the *sedes materiae* of the basic rules governing parent-subsidiary relations. Sections 291, 292 describe six different kinds of contractual arrangements which typically change the internal structure of the enterprises involved.[28] All of them are so-called "Enterprise Contracts" (Unternehmensverträge). The most important agreements are defined in Section 291 (1) as

> Contracts by which a stock corporation . . . subjects the direction of its corporation to another enterprise (contract of domination), or by which it obligates itself to transfer all its profits to another enterprise (contract to transfer profits).

[27] *See* Kropff, BB 1965, p. 1285; Stein, p. 105.
[28] *See* Kropff, Bergründung, p. 376.

The contract of domination is the typical agreement by which parent-subsidiary relations are made subject to statutory recognition and regulations which change the "personal law" of a corporation, especially the relations between the subsidiary and its shareholders. Normally the contract of domination is combined with a contract to transfer profits.[29] The adjustment of the conflicting interests is sought by balancing out the power to direct of the dominating enterprise and the protection of the dependent corporation, of creditors and outside shareholders.

A. Under a contract of domination Section 308 (1) grants the dominating enterprise the *right to give directives* to the executive board of the subsidiary corporation. The directives may be disadvantageous to the subsidiary if they serve the interests of the dominating enterprise, or of the enterprises related to it and the subsidiary corporation in a combine. It is important to note that the basic change in the law is the now legally recognized shift of the decision-making power to the dominating enterprise, and the recognition of the interests of parent-subsidiary relations to the extent that decisions disadvantageous to the subsidiary are justified, as long as they prove to be to the economic advantage of the combine.[30]

It follows that the pursuit of non-economic interests and that of interests of third parties including, *e.g.* single shareholders) is regarded as being outside of the scope of this privilege.[31] This limitation of the power of the dominating enterprise cannot be contracted away, insofar as the law is mandatory. But the parties are not prevented from including further limitations which may be necessary from a practical point of view, in order to get the necessary consent of outside shareholders (those not connected with the controlling group).[32]

The purpose of this rule is further stressed by an express provision that the executive board of the subsidiary is obliged to follow the directives of the dominating enterprise, except when they obviously do not serve the statutory interests, Section 308 (2).

B. *Protection of the Subsidiary and Its Creditors.* Contracts of domination as well as contracts to transfer profits do not only endanger the outside

[29]The "other enterprise contracts" defined in § 292 do not change the functions of the organs of a dependent corporation, and are beyond the scope of this paper. For a short survey see Haskell, THE BUSINESS LAW., 425 (1969) Würdinger, pp. 302–308, and Zöllner JuS 1968, pp. 301–302.

[30]*See* Godin-Wilhelmi, p. 1618 Mestmäcker, Festgabefür Kronstein, p. 135, emphasis 2ed. that the dominating enterprise has the power to influence the subsidiary in a way which makes other persons liable under § 117.

[31]*See* Rehbinder, AWD 1969, p. 349; Kropff, Begründung, p. 403.

[32]*See* Kropff, Begründung, p. 403; Godin-Wilhelmi p. 1618 f.

shareholders' interest. They represent a considerable risk for the corporation itself and its creditors. For normally a subsidiary will hardly accumulate earnings or capital reserves. Therefore Section 300 of the new law provides that a subsidiary must maintain certain minimum capital reserves. In addition, the law defines the maximum amount of profits which may be transferred, Section 301.

Most important is the protection effected by Section 302: the dominating enterprise has to assume the losses which the subsidiary sustains so long as the contract of domination and/or the contract to transfer profits remains in effect. If such a contract terminates, the parent enterprise has to render security to the creditors of the subsidiary corporation, or, alternatively, to guarantee the claims, Section 303. Thus the power to direct the subsidiary is accompanied by the financial responsibility of the parent enterprise toward the creditors.

C. *Protection of Outside Shareholders*

(a) The provisions dealing with the conclusion, amendments and termination of enterprise contracts, provide for the protection of outside shareholders. The text of any such contract must be made available to any shareholder of any corporation which may be a party to the contract prior to the shareholders' meeting. In addition, the substantial information of the shareholders is required, Section 293(3) and (4). The contract becomes effective only with the consent of the shareholders' meeting (at least three fourths of the share capital represented at the meeting, Section 293(1).

While the effectivity of the American proxy rules is sometimes doubted as they vest substantial power in the corporate management, one has to take into account that in Germany most of the shareholders leave their representation to the banks with which their shares are deposited.[33] So the banks which propose a vote may exercise additional control. A recent case proved that a group of more than twenty-five per cent of shareholders represented by a bank had sufficient bargaining power to insist on much more favorable conditions for outside shareholders.[34]

(b) But outside shareholders who do not own twenty-five per cent of the share capital do not lack all protection. For they must be given either a right to reasonable compensation or an option to withdraw upon appropriate indemnity, Sections 304 - 307.

[33] *See* Steefel/v. Falkenhausen, 52 CORNELL L.Q. 542 (1967).

[34] *See* Beuthien, JuS 1970, p. 58, who gives a detailed survey on the merger of the NSU AG. into a subsidiary of VW AG.

The reasonable compensation consists of a guaranteed annual dividend in the amount of at least the average dividend, which normally could be distributed to a share. A contract without such a provision is void, Section 304.

Furthermore the dominating enterprise is obliged to offer an indemnity to those outside shareholders who want to dispose of their shares. In general the shareholder may elect to be paid the fair value of his holdings, in capital stock of the parent corporation if it is a corporation with domestic domicile, or in cash.

The amount of both the compensation and the indemnity can be determined by the court if they are not reasonable in the outside shareholders' opinion.

(c) Once a contract of domination has become effective, the dominating enterprise obtains a comprehensive right to direct the subsidiary corporation.[35] But this power is accompanied by certain liabilities of the parent and its legal representatives.

First of all the legal representatives of the parent are to employ the diligence of an orderly and conscientious manager in giving directives to the subsidiary corporation, Section 309. If they violate this duty then they are jointly and severally liable to the corporation. As it is unlikely that the executive board of a subsidiary will sue the representatives of the parent any damage claim may also be asserted by every shareholder and under special conditions by creditors. It is interesting to note that the law treats the outside shareholders in this context as a group with special rights. For the corporation may only waive or settle the damage claims if the outside shareholders consent by special resolution. Any such waiver or settlement can be vetoed by a minority representing at least ten per cent of the share capital, Section 309(3).

The new statute does not provide a liability of the dominating enterprise except in the case of a single trader.[36] But the explanatory statement accompanying the Government draft bill, suggests that the parent itself is liable under general principles if its representatives violate their statutory duties.[37] This opinion has since been adopted by a considerable number of legal writers,[38] a

[35] *See supra*, p. 12.

[36] *See* Beuthien, JuS 1970, p. 55.

[37] *See* Kropff, Begründung, p. 404 f.

[38] *See* Godin-Wilhelmi, at 1621; Beuthien, JuS 1970, p. 55; Mestmäcker, Festgabe Kronstein, p. 1335 f.; Würdinger, p. 291; although it is still unclear which general principle exactly will apply, as Beuthien and Mestmäcker point out.

fact which is certain to be taken into account if German courts will have to decide this question.

Finally the members of the executive board of the subsidiary corporation are jointly and severally liable if they have acted in violation of their duties. But often the executive board of the subsidiary will not have the necessary information to determine whether their acts are really advantageous for the combine as a whole. So their liability is excluded if the damaging action rests upon a directive of the parent which they had to follow pursuant to Section 30842).

4. RESPONSIBILITIES IN THE ABSENCE OF A CONTRACT OF DOMINATION

If no contract of domination is concluded the question arises as to which way the different interest groups can be protected against the influence of a controlling parent. Moreover all provisions based on a contract of domination, may be proved obsolete if as a practical matter a parent could exercise its influence without submitting itself to the statutory restrictions which are characteristic for parent-subsidiary relations under a contract of domination. Quite a number of proposals were made to cope with this problem including the prohibition to exercise any influence and very strict liability rules.[39]

The final solution of the new law is based on the principle that a dominating enterprise must not use its controlling interest in (and thus de facto control over) a corporation to the prejudice of the controlled party, without affording it specific compensation within the same fiscal year, Section 311 (1). This principle is opposed to the power to direct a subsidiary under a contract of domination.

Although a similar restriction did not exist under the old law,[40] one cannot deny that the new law still recognizes the controlling power of a parent to a large extent: The law impliedly recognizes that a parent enterprise usually influences the management of the subsidiary, and permits disadvantageous decisions under the condition that compensation be paid.[41]

Several stringent provisions on liability for damages are to make sure that Section 311 is complied with: The dominating enterprise, its legal representatives, and the members of the executive board of the subsidiary are jointly and severally liable if they violate the duties concerning the

[39] *See* Kropff, Begründung, p. 375 and BB 1965, p. 1281.
[40] *See* Kellman, BB 1969, p. 1510.
[41] *See* Würdinger, p. 309.

compensating provisions, Sections 317, 318. But it is doubtful whether these provisions offer sufficient protection of the interests of the subsidiary, creditors, and outside shareholders. Shareholders and creditors can hardly prove that the compensation provisions were violated[42] as they are not informed about the conditions of transactions between the enterprises.

The lawmaker tried to take these difficulties into account.[43] As a result, the subsidiary is required to report annually all transactions induced by, or serving the interest of, the controlling enterprise, Sections 312 *ff.* The report must also include all transactions taken with other related enterprises of the parent. As to compensation, the report has to state in detail how the compensation did in fact take place.

This report has to be submitted to independent auditors and to the supervisory board, Sections 313, 314. This means of supervision is much more important in practice than the potential liabilities, to deter parents from avoiding the conclusion of a contract of domination. In fact, in quite a number of cases it was frankly admitted that the only reason for forming a contract of domination had been to avoid the duty to report under Section 312.[44]

III. Transnational Parent-Subsidiary Relations

If a combine is formed by a German and a foreign enterprise, the question arises to the extent to which these relations are subject to the new German law on related enterprises, or whether these relations are governed by a different national legal system. Some of these questions are expressly solved in the Corporate Code: *e.g.*, integration of a corporation is only possible into another corporation with domestic domicile, Section 319. Consequently this form of enterprise relations is not available for the organization of multi-national enterprises.[45]

Another example is to be found in Section 330(2), which contains a special provision on the preparation of consolidated financial statements, if the combine direction has its domicile abroad. These provisions show that not all questions concerning the reach of the new Corporate Code were left to the conflict of laws. Therefore one must examine which provisions of the parent-subsidiary rules determine the application in situations in which a foreign enterprise is involved, and the relation of these provisions to the principles of the conflict-of-laws rules has to be clarified.

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[42]*See* Rasch, p. 168.
[43]*See* Kropff, Begründung, p. 411.
[44]*See* the examples given by Meilicke, p. 119.
[45]*See* Koppensteiner, p. 219; Würdinger, pp. 221 and 279.

1. NATIONAL AND TRANSNATIONAL REACH OF THE PARENT-SUBSIDIARY RULES

A. *Related Enterprises.* With regard to the duties imposed by the law on related enterprises in a broader meaning of the word[46] the substantive law regulates the application as follows.

The reporting requirements in Section 20(1) and (4) do not distinguish between foreign and domestic enterprises, holding an interest of more than twenty-five or fifty per cent of the shares of a stock corporation with domestic domicile. This indicates that foreign business enterprises are subject to the reporting requirements. As the interest of information of creditors and investors is the same, regardless which enterprise is involved, it is generally held that foreign enterprises also must give the required information.[47]

The other provisions requiring the executive board to inform the supervisory council or shareholders,[48] are part of the rights and duties of the constitutional organs of a German corporation. The duty to inform includes the relation of the corporation to foreign enterprises. But as this duty is only imposed on the organs of a German corporation, it is equally clear that these provisions do not regulate the respective rights and duties of foreign enterprises. Similarly the provisions on the data to be included in the reports of the management and the annual balance sheet[49] apply only to the German corporation, not to the foreign enterprise to which the German corporation is related.

The limitations on subscription to, and acquisition of, shares by a dependent enterprise – Sections 56(2) and 74(4) – intended as a guarantee that a corporation will not circumvent the prohibition to acquire its own shares. So the purpose of this prohibition is the protection of the capital assets of the German parent corporation. Therefore, this provision is interpreted to apply only when a foreign enterprise is dependent, and a German corporation is dominating. It is not the objective of these provisions to protect foreign parent corporations.[50] Thus a German subsidiary corporation may acquire shares of its foreign parent.

The third group of provisions protecting the decision-making process in corporations is construed in the same way: the suspension of the voting rights of dependent enterprises by Section 136(2), purports to regulate only

[46] *See supra*, p. 8.

[47] *See* Godin-Wilhelmi, p. 95; Koppensteiner, p. 285; Würdinger, p. 264; Baumbach-Hueck, p. 54; Bernhardt, BB 1966, p. 679.

[48] *See supra*, p. 9.

[49] *See* Koppensteiner, p. 294.

[50] *See* Würdinger, p. 21; Grasmann, p. 455; Koppensteiner, p. 28.

the decision-making of a domestic corporation, without giving the management the possibility of influencing the shareholders' resolutions.[51] As far as the granting of credits to the legal representatives of a dependent enterprise is concerned, the restrictions of Sections 89(2) and 115(1) apply whether it is dominated by a domestic or a foreign corproation.[52]

B. *Power of Control and Responsibilities*

(a) The central question concerning parent-subsidiary rules is of course whether a foreign corporation can be a party to a contract of domination. The language of Section 291 "by which a stock corporation (Aktiengesellschaft) or a corporation limited by shares (Kommanditgesellschaft auf Aktien) subjects the direction of this corporation to another enterprise . . ." is not as clear as the language of comparable provisions. But there are a number of reasons why most legal writers think that a German corporation can subject its direction to a foreign enterprise.[53]

First of all, one can conclude from the regulations of two other provisions that the legislature has recognized the problems which arise as a consequence of the growing international concentration. Section 319 expressly forbids integration into a foreign corporation. As Section 291 does not contain a similar prohibition, one may argue *e contrario* that the law permits the conclusion of a contract of domination which subjects a German corporation to the directive of a foreign enterprise.[54]

Furthermore Section 305(2)(no. 1) provides a special rule for the indemnity which has to be offered to outside shareholders: if the dominating corporation is not a corporation with a domestic domicile then the indemnity has to be in cash instead of shares of the dominating corporation.

In addition Koppensteiner points out that the underlying policy of the new provisions as to the contract of domination, as well as on the responsibilities in the absence of a contract of domination, is to make dominating enterprises enter into the formal agreement.[55] The legislative history[56] clearly shows the reluctant attitude of the legislature concerning the exercise of *de facto* control.

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[51] *See* Würdinger, p. 21; Koppensteiner, p. 291.

[52] *See* Koppensteiner, p. 295.

[53] *See* Barz BB 1966, p. 1168; Godin-Wilhelmi, p. 1513; Möhring-Tank-Grass-Reuss, comment no. 736; especially Koppensteiner, p. 245 ff.

[54] *See* Koppensteiner, p. 245.

[55] *See 2d* Koppensteiner, p. 246.

[56] *See supra*, p. 143.

An interpretation neglecting this purpose seems to be inconsistent with the objectives of the new rule[57] So a contract of domination between a foreign enterprise and a German corporation is valid under Section 291.

The right to give directives, even disadvantageous to the German subsidiary corporation, exists under Section 308(1) as long as the directives are of economic benefit to the combine as a unit. An interesting question arises here due to the fact that parent and subsidiary are subject to different legal systems, and "citizens" of countries which may pursue different foreign trade policies: *e.g.*, a business transaction may be forbidden to the American parent under the Trading with the Enemy Act, whereas such a business is permitted under the law of the subsidiary.

If the American parent directs its subsidiary corporation to do business only in compliance with the American restrictions, then this directive is not of any economic advantage to the combine, unless the American parent would show that it suffers economic losses otherwise. So directives, the only purpose of which is to enforce conformity with regulations of the parent's home country, are generally not regarded as a justification for disadvantageous decisions within Section 308(1).[58]

The provisions protecting the interest of the subsidiary corporations, its creditors and the protection of outside shareholders, form the body of law which governs the relations of parties to a contract of domination. Section 305(2)—as mentioned above—contains a special provision that a foreign parent may offer an indemnity in cash only. As the other provisions do not distinguish between foreign and domestic dominating enterprises, the rules apply as outlined above.

(b) The same result is true for the provisions on responsibilities, which arise when a dominating foreign enterprise exercises its control power without having concluded a contract of domination.[59] For the purpose of this group of provisions is the protection of the corporations organized under the German Corporate Code against the dominating influence of other business enterprises. So from the teleological point of view it does not make any differ-

[57]*See* Meilicke, pp. 118-121.

[58]*See* Rehbinder, AWD, 1969, p. 348, especially note 24 concerning the Fruehauf case; Koppensteiner, p. 319.

[59]*See* Würdinger, p. 21; Godin-Wilhelmi, p. 86; Koppensteiner, pp. 294, 296.

ence, whether this influence is exercised by a domestic or foreign enterprise.

C. *German Parent and Foreign Subsidiary.* Relations between a German parent corporation and a foreign subsidiary do not present a great problem under German law. Most of the provisions of Book Three on related enterprises, deal only with the case in which a German corporation is subject to the influence of a dominating enterprise. Consequently the law does not apply when a foreign subsidiary corporation is involved.[60]

Whether a German parent corporation has to obtain the consent of its shareholders' meeting under Section 293(2) when a contract of domination is concluded with a foreign subsidiary, seems to be a question of little importance as long as other legal systems have no institutions which could be compared to the contract of domination. It is suggested that if such a contract would impose duties on the German parent similar to those in Sections 300–310, then Section 293(2) would apply.

Besides the duties which are part of the law of related business enterprises,[61] the law contains only some provisions on the preparation of consolidated financial statements: under Section 329(2) a German parent is free to include statements on a foreign subsidiary corporation.[62]

2. CONFLICT OF LAWS' RULES ON PARENT-SUBSIDIARY RELATIONS

There are no statutory provisions containing the law of the conflict-of-laws rules of corporations. But it is generally recognized that questions concerning the "international private law" of corporations[63] include the fields of contractual liability, liability in tort and the "personal law" of corporations.[64] The personal law includes the regulations of all internal affairs of a corporation, such as the relations between organs and the corporation, relations between the organs 'inter se' and organs 'inter se'.[65]

If business corporations which are subject to different legal systems[66]

[60]*See* Koppensteiner, pp. 98, 266–268.

[61]*See supra*, p. 145.

[62]For a further discussion of related questions, *see* Koppensteiner, pp. 324–28; Würdinger, p. 22.

[63]This is the terminology known in most countries; *see* Steiner/Vagts, p. 79.

[64]*See* Fikentscher, MDR 1957, p. 73.

[65]*See* Fikentscher, MDR 1957, p. 73; Raape, p. 201; *cf.* Rabel, p. 69 ff.; ILA-Report 1962, p. 88.

[66]The problem of determination of a company's personal law is not within the scope of this paper, as the question discussed presuppose that the enterprises involved are subject to different legal systems. As to the difficulties which may arise when there are two connecting factors (incorporation and domicile) see Fikentscher MDR 1957, p. 74.

become "related enterprises," the question arises as to which law governs these relations. As far as the substantive law regulates the application of provisions in these situations, one has to examine whether these rules are compatible with the recognized principles of the international private law.

A. *Related Enterprises.* The duty of business enterprises to inform a German corporation of which they own more than twenty-five per cent or fifty per cent is part of the regulations which deal with the relation between a German corporation and its shareholders.[67] That this is the legal concept is clearly shown by the sanction of suspension of the shareholder's rights. This duty belongs therefore to the personal law of the German corporation.

The application of this provision on foreign enterprises, which own shares of a German corporation is a matter which belongs to the personal law of a domestic corporation under German conflict of laws principles.[68] The information of shareholders and supervisory council by the executive board, also concerns the internal relations of a German corporation, and to that extent qualifies as a problem to be dealt with by the personal law.

The prohibitive provisions on subscription to and acquisition of shares by a dependent enterprise, serve the purpose of protecting the capital of a domestic parent corporation. The provisions on raising and preserving the capital of a corporation are generally regarded as being within the scope of the personal law.[69] As Sections 56(2), 71(4) regulate this matter, their application on foreign dependent enterprises and non-application to foreign parent corporations, conform to the conflict of laws rules. Similarly the provisions which protect the decision-making process in German corporations are within the scope of the personal law of these corporations, since they govern internal corporate relations.

B. *Power of Control and Responsibilities.* The main criterion of the contract of domination—as described—is the shift of control from the organs of the dependent domestic corporation to the dominating enterprise. Thus, this contract fundamentally changes the corporate organization as the dependent corporation surrenders its autonomy. On the other hand, the very detailed rules protecting the interests of the subsidiary, its creditors and outside shareholders, balance out the disadvantages of this shift of control. These rules constitute a uniform system which cannot be broken up. All the rules on the contract of domination, qualify as the personal law of a German subsidiary corporation.[70]

[67] *See* Bernhardt, BB 1966, p. 679; Kropff, Begründung, p. 39.

[68] *See* Baumbach-Hueck, p. 54; Würdinger, pp. 21, 264; Bache, p. 110; Koppensteiner, p. 285.

[69] *See* Koppensteiner, AWD 1970, p. 437, and *op. cit.* p. 288; Würdinger, p. 21; *cf.* ILA Report, 1954, pp. 390 *f.* and Draft Convention on Conflict of Laws Relating to Companies, ILA Report 1960, art. 3, p. 93.

[70] *See* Würdinger, p. 21; Koppensteiner, p. 310.

Similarly the rules on parent-subsidiaries provide a system in Sections 311 *ff*, which intended to balance the divergent interests involved. Furthermore, one must take into account the interdependence between the rules governing a contract of domination, and the provisions on *de facto* control. Therefore it is generally held that Sections 311 *ff* are part of the personal law of a German subsidiary corporation.[71]

C. The relations between a *German parent corporation and a foreign subsidiary* are not regulated by the rules on related enterprises in Book Three of the Corporate Code. This concept is convincing, as there is no need for the German legislature to protect the interest groups of corporations which are not organized under German law.

3. CONCLUSION

The new German Corporate Code contains a number of provisions on related enterprises which apply to dominating or dependent enterprises. But as far as the substantive law claims to reach transnational situations the questions involved concern the relations between organs and a German corporation, the relations of a German corporation and its members, between the members *inter se*, and the organs *inter se*. These matters are generally regarded as part of the personal law of a corporation.

Similarly the rules governing the power of control and responsibilities arising in a parent-subsidiary relation, regulate only matters which require the protection of domestic corporations, and of the groups connected with it. This concept also conforms to generally recognized conflict of law rules.

These principles are not only part of the German conflict-of-laws rules, but are recognized in most countries.[72] Therefore, there is a chance that foreign courts might reach the same decision as to which law is applicable, if they have to deal with a situation which involves relations between a foreign business enterprise and a German corporation. From this point of view the new rules are compatible with one of the principal policies in the field of choice of law:[73] to seek uniformity of result, whatever the forum in which an action might be brought.

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[71]*See* Würdinger, p. 21; Koppensteiner, p. 294 and AWD, 1970, p. 438 f.; Rehbinder, AWD 1969, p. 348.

[72]*See, e.g.*, Rabel, p. 69; Steiner/Vagts, p. 83*ff*. Arts. 3 and 4 Draft Convention on Conflict of Laws Relating to Companies, ILA Report 1962, p. 93.

[73]*See* Steiner/Vagts, p. 80.

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